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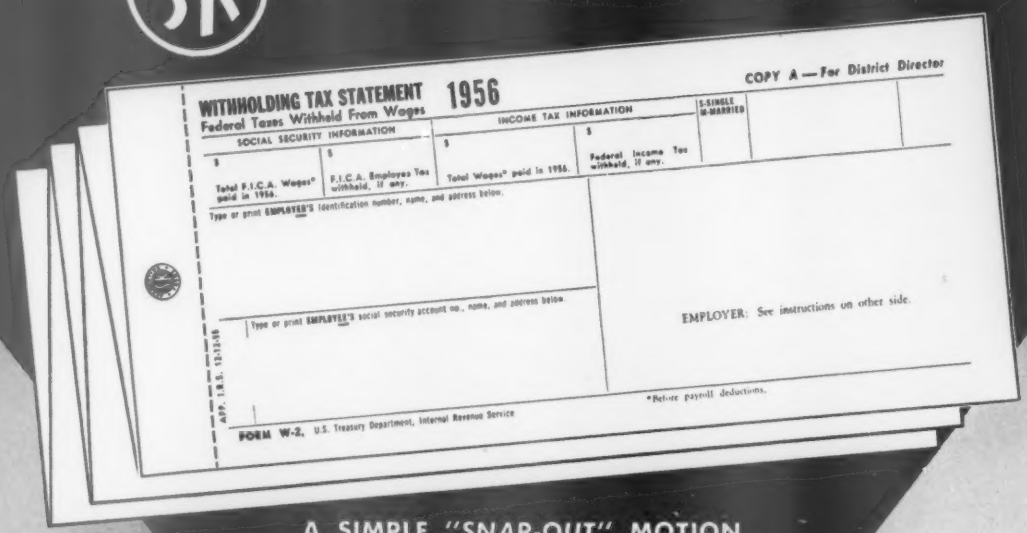

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Depletion for tax purposes: a condensed picture of how it works in mining

by F. A. GOULETTE

Current advantages arising out of investment in mining are forcing many practitioners, heretofore remote from these specialized industries, to get a working knowledge of both the tax aspects and the technical facts upon which tax considerations rest. This article is a concise picture of the whole field of depletion: percentage, cost, etc., what it means, how it works; the advantages and traps. It is not for the expert, though the knowledgeable may benefit from the organized way in which depletion under the new Code is here presented. Its purpose is to make the general tax practitioner sufficiently aware of tax effects of depletion to serve his clients to whom depletion is of interest.

DEPLETION IS ONE of the most important tax factors in the mining industry. There are two kinds of depletion—physical and economic. Physical depletion, with which we are not here concerned, may be defined as the wasting away of a deposit of minerals, oil, or some other natural resource. For accounting and tax purposes we are concerned with economic depletion, which may be defined as the write-off of the basis of a natural resource as the supply diminishes or wastes away. This may be considered as somewhat analogous to the expensing of the cost of raw materials consumed in manufacturing.

The owner of an "economic interest" in the mineral property being depleted is the only one who may deduct depletion with respect to such property. The term "economic interest" was not defined in either the 1939 or the 1954 Code, and has been and still is the subject of much litigation. The United States Supreme Court in *Palmer v. Bender* (287 U.S. 551) established the principle that the depletion deduction is available to those persons having the right to share in the minerals produced, and from this decision there evolved the following definition, which appears in the Regulations:

"An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in minerals in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital."

Some minerals, such as coal, are sometimes found relatively near the surface, and by a process called strip mining the covering earth or overburden is removed and the coal is stripped out. In many cases the owner of the coal property will execute an agreement with a contractor under which the latter will undertake to remove the overburden and mine the coal. Because the agreement may involve both services and mining, the question immediately arises as to whether the contractor has obtained an economic interest in the coal entitling him to depletion.

The contractor is deemed to have an economic interest where: (1) the contract cannot be terminated at the will of, or upon nominal notice by, the coal company, (2) he obtains a capital interest in the coal, and (3) he must look solely to the extraction and sale of the coal for his compensation. If, under the contract, compensation is derived partly from extraction and sale of coal and partly from removal

of overburden and other services, only the portion of compensation attributable to the extraction and sale of coal is subject to depletion.

The court decisions, Regulations, and rulings all lead to one overwhelmingly basic principle with respect to economic interest: that is, a person must own a right to a share of the minerals produced, or a share in the proceeds of sale of such minerals, to which he looks for the return of his investment. The taxpayer need not incur any cost nor have any tax basis with respect to his investment. Also, he may own such a right for tax purposes, even though under state law he doesn't have legal title to the mineral in place. However, if a right permits its owner to receive payments from some source other than solely from a share of production, it is not an economic interest.

A good part of the litigation in this area seems to arise because the taxpayer intended to acquire or retain an economic interest when he made the assignment, lease, or what have you, but later found the Commissioner saying he had not.

COST DEPLETION

Under the 1954 Code there are two permissible methods of computation, cost depletion and percentage depletion. Under the 1939 Code there was a third method, discovery-value depletion. This method applied to mines discovered by the taxpayer after February 28, 1913, which were not subject to percentage depletion. It was provided that the basis for depletion should be fair market value of the property, with certain limitations, at the date of discovery or thirty days thereafter. The depletion deduction was limited, however, to 50% of net income from the property, but not less than cost depletion. Since nearly all minerals are now subject to percentage depletion, the 1954 Code eliminated this method.

For book (accounting) purposes, depletion is usually computed under the cost method, though percentage depletion is sometimes used. This method is used for tax purposes only when it produces a higher deduction than the percentage method. It is computed as follows:

$$CD = \frac{S}{R + S} \times B, \text{ where}$$

CD = Cost depletion
S = Units sold during period
R = Remaining units at end of period (reserve)
B = Adjusted basis of mineral interest at end of period.

Sales are deemed to be made in the year in which the proceeds are taxable under whatever method of accounting is employed by the taxpayer in keeping his returns. Generally, depletion is allowed only on the basis of units actually sold, and not on the basis of units produced. Thus depletion is not allowed for minerals consumed in operating the property or those destroyed prior to sale. Oil and gas companies may take percentage depletion on oil or gas used in refinery operations. Therefore, you may often find in practice that the general rule is not followed.

The total recoverable (barrels, tons, pounds or other measures) of mineral products that are reasonably believed to have existed in the ground on the date the property was acquired, or other valuation date, such as March 1, 1913, are usually referred to as *mineral reserves*. A depletion unit is obtained by dividing the remaining basis of the property by the estimated reserves. When, by reason of operations or development work, it is determined that the recoverable units are greater or less than the original estimate, the reserves must be revised. The revision results in a new depletion unit. The new depletion unit usually has no effect on and is not applicable to prior years, even though there may have been excessive depletion allowances in prior years.

Fair market value

It is not unusual to find that the fair market value of the mineral interest on a particular date represents the basis for depletion. This is so when the mineral interest is acquired by gift, from a decedent, in a taxable exchange (for stock, bonds, other property, etc.), or was acquired prior to March 1, 1913.

The determination of the fair market value of a mineral interest depends on a number of factors, any or all of which may be present in a particular case. The factors, in order of importance according to the Internal Revenue Service, are as follows: (1) actual bona fide sale price, (2) a bona fide offer to purchase, (3) a bona fide offer of sale, (4) the sale price of similar properties, similarly situated, (5) market values of stocks when they fairly and clearly represent the value of the property, (6) royalties or rentals paid or received, (7) analytical appraisals by the present-worth method, and (8) valuations for purposes of state and local taxation and appraisals for court proceedings.

A method of computation frequently used by the Commissioner is that of analytical appraisal, because it is often found that most of the other factors are not available. However, it has been ruled that this method should be resorted to only in the event that the fair market value cannot be reasonably ascertained by any other method (GCM 45, CB June 1926, p. 65). The computation is predicated on the discounting of total expected earnings from the property to present value by use of Hoskold's Formula, which provides the discount factors in the form of a table. This table, together with an explanation of its assumptions and use, appears in the tax services.

For book purposes the reserve for depletion is usually credited or basis is reduced only by cost de-

pletion. On the other hand, for tax purposes the basis is reduced by either cost or percentage depletion, whichever is higher. Thus, book basis and tax basis may be different, with a consequent difference in cost depletion and gains or losses from disposition. In neither case is basis reduced below zero.

PERCENTAGE DEPLETION

The deduction for percentage depletion depends solely on mineral sales and not on basis. That is, it is allowable even after the basis has been reduced to zero (Section 1016 (a) (2)).

Percentage depletion is probably one of the most publicized and controversial deductions in the tax law. The controversy seems to arise principally between those persons who believe it is a necessary incentive to the natural resources industry and those persons who believe it is an inequitable concession to that industry.

This method of depletion is provided in Section 613, and is allowed for at varying rates for all minerals except:

1. Minerals derived from sea water, the air, or similar inexhaustible sources.
2. Soil, sod, dirt, turf, water, and mosses.
3. Coal (including lignite), held for more than six months, the disposal of which is treated as a sale under Section 631 (c) subject to long-term capital-gain treatment.

Section 613 also contains a complete list of all the minerals subject to percentage depletion together with the applicable rates.

The computation is made by multiplying the gross income from the property during the taxable year, after deducting rents or royalties paid thereon, by the applicable percentage. This amount, however, may not exceed 50% of the taxable income from the property computed without depletion. In any event the amount allowable shall not be less than cost depletion (Section 39.23 (m)–5 (a), and 1 (e) (5), Reg. 118). The computation may be reduced to a rather simple statement: "The amount deductible is either a percentage of gross income from the property or 50% of taxable income from such property, whichever is the lesser, but is never less than cost depletion."

Gross income from the property

Gross income from the property was first defined by the Revenue Act of 1943, and the 1950 Act included therein transportation (not in excess of 50 miles) of ores and minerals. Section 613 (c) (1) now defines this element as being gross income from *mining*, and mining is defined in Section 613 (c) (2) as follows:

"The extraction of the ore or mineral from the ground plus the ordinary treatment processes normally applied by the mine owner or operator to obtain a commercially marketable mineral product or products, and plus transportation, not to exceed 50 miles, of the ore or mineral from the point of extraction to the plant or mill in which the ordinary treatment processes are to be applied. The transportation may or may not be by common carrier, and may exceed 50 miles if it can be shown that physical and other requirements necessitates transportation over a greater distance."

If the crude mineral is sold at or near the mine, gross income is simply the selling price and we have no problem. It is rarely this simple, because it is usually necessary to transport the ore to a mill for treatment in order to get a commercially marketable product. That is, the ore in its raw state is not salable, and because mines are frequently in isolated locations it is not feasible to construct a mill at the mine location.

Ordinary treatment processes, the value of which may be included in arriving at gross income, are those processes that must be applied to the ore or mineral to obtain a "commercially marketable product." The Code specifies such processes for only a few minerals and classifies all the rest as between those usually sold in the crude state and those not sold in such state. Further, there is nothing in the law with respect to when a "commercially marketable product" is first obtained, and this leads to many questions, since all processes to that point are allowable whether or not they are specified in Section 613 (c) (4).

The Cherokee Brick conflict

The *Cherokee Brick & Tile Co.* case[1] is an important landmark in this area because it upholds the principle that gross income may be the selling price of the end product where there is no market for the mineral at any stage between extraction from the ground and loading for shipment. Specifically the court held that gross income from mining was the selling price of the finished brick and tile, f.o.b. plant, loaded for shipment, whereas the Commissioner contended that only certain processes were includible as "ordinary treatment processes" and the remainder were manufacturing processes so that gross income should be computed at an intermediate point.

In the *Cherokee* case, the court also made a distinction between "ores" and "minerals." This distinction is important because the Regulations indicate that there shall be *excluded* as ordinary treatment processes the roasting, pulverizing, pressing into shape, and molding of ores. The court held that brick and tile clay is a "mineral" and not an "ore," and, therefore, these processes are includible, because the statute does not exclude them in connection with the mining

[1] *Cherokee Brick & Tile Co. v. U.S.* (DC Ga, 1954), 122 F. Supp. 59, paragraph 72594 P-H Fed. 1954, *aff'd* CCA-5, 218 F.2d 424, which is contrary to Rev. Rul. 54-109, IRB 1954-12.

of minerals. (The IRS has announced in Rev. Rul. 55-244 that it will not follow the *Cherokee* case.)

Transportation

Despite the general rule, transportation in excess of 50 miles may be permitted, if the taxpayer satisfies the Commissioner that both the physical and other requirements are such that the ore or mineral must be transported a greater distance. In essence it would seem that the taxpayer must be prepared to show that the treatment plant is constructed as close to the point of extraction as is physically and economically possible without causing undue hardship to the operation.

If the product in its crude mineral state is merely transported and sold, the selling price minus transportation cost is used as gross income. If the taxpayer provides his own transportation, profits as well as costs attributable thereto must be deducted. For example, the Senate Finance Committe Report on the 1954 Code states that, in the case of uranium, gross income will be determined by reducing the sales price of the ore by the net transportation cost to the taxpayer, such cost being the taxpayer's transportation cost reduced by the hauling allowance allowed by the Atomic Energy Commission. Furthermore, the Internal Revenue Service has held, with respect to the sand and gravel business, that a delivery loss reduces gross income from the property.

If the crude mineral is transported 50 miles or less (or more with the approval of the Commissioner) to a mill where ordinary treatment processes are applied, and then sold, gross income is again simply the selling price.

If the crude mineral is transported more than 50 miles (without the Commissioner's approval) to a mill and/or is treated beyond the "ordinary treatment processes" before sale, gross income may be computed by reference to the representative market or field price (on the date of sale) of a mineral product of like kind and grade to which ordinary treatment processes have been applied and which has no excess transportation. Also, the Internal Revenue Service may permit the use of a field price, even though not all of the product is sold in the same form. That is, if, say, 15% to 30% of the product is sold in a form that has a field price, whereas the remainder does not have a field price, the price of the former may be used for the whole product.

Cut-off point

Little or no difficulty is encountered in computing gross income in these situations. It is when processing beyond the first commercially marketable point, usually called the cut-off point, and transportation beyond that allowable is coupled with a lack of a representative market or field price, that our computation problems really begin. In this case you must compute the price at the cut-off point. According to the regulations this is done by taking the price of the first marketable product and reducing it by the costs and proportionate profit attributable to the unallowable processes. Also, the costs and proportionate profit attributable to any unallowable transportation must be deducted.

Another method would be to determine the costs attributable to the unallowable processing and/or transportation either directly or by allocation, and deduct such costs from total costs to arrive at the cut-off point cost. Gross income might then be determined by multiplying the cut-off point cost by the percentage mark-up of the product that is being sold. For example, if the sales price of the product being sold is 120% of total processing costs, gross income at the cut-off point might be 120% of cut-off point cost.

In some cases several minerals are mixed or blended with other material in the manufacture of the finished product. As an example, calcium carbonates, shale, and clay are mined, crushed, and ground, and then blended with other materials to produce cement. The Internal Revenue Service has ruled that gross income must be computed separately with respect to each component mineral.

Gross income may, at times, be computed in a rather aribitrary manner, since the Regulations provide that the taxpayer can use any method that, to the satisfaction of the Commissioner, clearly reflects gross income. For example, the IRS permits the allocation of gross income as between the cut-off point and the point of sale on the basis of the ratio of cut-off point costs to total costs. However, this method may penalize an efficient producer. For instance, in the cement business a producer with a low quarry cost would get less percentage depletion than one with a high quarry cost.

It is fairly easy to visualize the not inconsiderable complications that may arise in computing gross income, because rarely do the accounts permit the ready determination or costs at the cut-off point. No doubt that is the reason why the Regulations provide that the taxpayer may use a method other than those indicated therein, if he satisfies the Commissioner that such method clearly reflects gross income.

Thus the computation of gross income is not made under any rigid formula, but varies according to the factual situation.

Under Section 613 (c) (3), which is new in the 1954 Code, the term "extraction of the ore or mineral from the ground" now includes the extraction by a "mine owner or operator" of ores or minerals from the waste or residue of prior mining. Thus it is now clear that mine dumps of waste mineral are subject to percentage depletion.

Payments to encourage exploration

Section 621 (Section 22 (b) (15) (of the 1939 Code)

provides that the taxpayer shall not include in his gross income any amounts received from the United States government as an incentive to explore for, develop, or mine a critical and strategic mineral or metal. The amount received is excludible from gross income even though it is in the form of a loan, which is finally forgiven or discharged.

Section 450 (b) of the 1939 Code lists the minerals to which Section 621 applies, and the Regulations provide that other minerals may be added from time to time upon being certified by the government that they are essential to the defense effort of the United States and are considered to constitute critical and strategic minerals. The taxpayer must actually undertake, upon approval by the government, to explore for, develop, or produce the strategic minerals involved, and must expend the amount received for that purpose and in accordance with the terms and conditions laid down by the government. Also, he must submit an accounting to the appropriate government agency showing that the amounts were properly spent.

Expenditures of the taxpayer attributable to amounts excludible from gross income under Section 621 are not deductible, and neither may they be added to the basis of the property for any purpose. However, if all or any portion of the Section 621 payments are later repaid to the government, the expenditures shall be expensed or capitalized, as the case may be, in the year of and to the extent of the repayment.

Rents and royalties deducted

Rents are not clearly defined in the law. However, it does seem clear that only rents based on production and paid to the owner of an economic interest are deductible in arriving at gross income, on which percentage depletion is computed. Payments not based on production, such as delay rentals, payments for exploration rights, and damages, are not deducted in arriving *at* gross income, but, rather, are deducted *from* gross income to arrive at taxable income.

Delay rentals: It sometimes happens that a prospective lessee of mineral property wishes to lease some promising acreage for a term of years, but does not want to commit himself to the immediate development of the property. In this case, it is usually provided that if mining operations are not begun by a certain date, the lessee must make fixed periodic payments to the lessor for the privilege of deferring such operations. These payments are called "delay rentals" and are distinguished from royalties and bonuses because they are not related to nor dependent on production.

The lessee may have agreed to pay the lessor's share of the ad valorem property taxes on the mineral-bearing lands. If these payments exceed the gross income from production, such excess is treated as a delay rental. The amount not in excess of gross income is treated as additional royalty.

The lessor must treat delay rentals as ordinary rental income not subject to depletion. The lessee may capitalize or expense such rentals at his election, on the premise that they are carrying charges on nonproductive property. Furthermore, he may make a new election each year, and a different election may be made for each nonproductive property.

Royalties: It is quite common for a mineral lease to provide that the lessor will be entitled to a designated share of production, either in value or in product, without being required to share the development and operation expenses. This share of production is called a "royalty interest" and payments to the owner of such an interest are royalties, usually referred to as overriding royalties. These royalty payments are deducted in arriving at the lessee's gross income.

The lessor is entitled to depletion on royalty income, and may compute it by either the cost or percentage method, whichever produces the greater deduction. The percentage method is generally used because information on the total expected royalties is seldom available.

Where a cash payment is received upon execution of a lease, the question arises as to whether it is a "down payment" on the purchase price of the mineral interest or an "advance royalty." The question is important because an "advance royalty" is subject to depletion, whereas a "down payment" is not.

For the payment to be an "advance royalty," the lessor must retain an interest in the minerals to which he looks for future income. For example, the presence of an overriding royalty makes the cash payment an advance royalty. On the other hand, if no royalty interest is retained and future payments are in reality installments on an agreed purchase place, the payment is a "down payment." It should be kept in mind that, if a corporation lessor is subject to the 52% tax rate, or an individual is subject to a tax rate that is relatively high, a sale with a capital-gains tax at 25% may produce more net income after taxes than would be produced by retention of a royalty interest with its appropriate percentage depletion.

Lease bonus: A mineral property may be so promising and in such demand that a prospective lessee is willing to pay a bonus, in addition to later royalties, to obtain the lease. Such a bonus is considered to be an advance royalty and as such constitutes depletable income to the lessor and deductible royalty by the lessee.

The lessee must deduct a proportionate part of the bonus for each year of production. In general the lessor may compute his depletion on a lease bonus by either the cost or percentage method, which ever is higher. There is an exception, however, where he receives a bonus on a lease of an *unproven* area.

In this case, the cost method may not be used because the mineral content cannot be reasonably estimated, and, consequently, the mineral value can rarely, if ever, be established. Also, the percentage method must be used where information as to the amount of total expected royalties is not available.

The depletion on the bonus is, of course, subtracted from the lessor's basis of his mineral interest, and the remaining basis is recoverable through depletion on subsequent royalties.

If a mineral lease is terminated without production, depletion previously allowed on a bonus or advanced royalty must be restored to the lessor's income in the year of termination, and a like amount is restored to the basis of the mineral interest. The fact that the lessor received no tax benefit from the depletion deduction will not prevent the restoration to income. However, any amount of production, no matter how small, avoids the restoration. Furthermore, if the lessor dies before the lease is terminated without production, no restoration is required for the year of death. Similiarly, no restoration need be made when property is disposed of by gift or in distribution of an estate. As to the beneficiary or donee, there seems to be nothing that would require him to restore any more to income than the depletion deducted by him after acquiring the property. That is, the depletion deducted by the decedent, donor, or estate need not be restored to the income of the beneficiary or donee, if the lease is terminated without production after he acquires it.

Minimum or advanced royalties: It is not uncommon for a mineral lease to provide that the lessee shall make annual minimum payments to the lessor for a fixed period regardless of production. These payments may constitute a delay rental, installment bonus, or minimum royalty, depending on the terms of the lease.

Payments made prior to production are treated as delay rentals, if the lessee can terminate the lease at the end of any annual period by not making the required minimum payment. If such payments cannot be avoided by terminating the leases, they represent an installment bonus which takes the same treatment as a lease bonus.

Annual minimum payments made after production begins are minimum royalties which are treated like ordinary royalties to the extent they do not exceed production. If the payments exceed the production applicable to the royalty interest, the treatment of the excess depends on whether it is recoverable from future production. Excess minimum payments, which are recoverable from the excess of future production over the specified minimum, represent depletable royalty income to the lessor. This is so even though the payments may not be earned by production, and even though the lessor might subsequently be required to repay a portion of the excess payments if the specified minimum is not produced from the property. As to the lessee, he is granted the option of deducting the excess payments from gross income either in the year of payments or in the year the payments are recovered from production. The election is made in the return for the first year in which payments are made under a minimum royalty clause, and is binding for all subsequent years and for all properties. Failure to deduct such payments in the year paid constitutes an election to deduct in the year of recovery. Any unrecovered payments, not repayable by the lessor, remaining at the time the lease terminates or is canceled are deductible at that time.

Excess minimum payments, which are not recoverable from future production, may be treated by the Internal Revenue Service as delay rentals, if the lessee can forfeit the lease by not paying the specified minimum royalties. If the lessee cannot forfeit the lease, it seems likely that the payments will be treated as a lease bonus.

Where minimum royalties are present in a lease agreement, the provisions dealing with them must be very carefully drawn by the attorney, lest the parties be denied the treatment they intend.

THE PROPERTY

When gross income, rents and royalties, or taxable income are discussed in connection with depletion, it is understood that these terms always relate to a mineral property. Thus, the definition of "the property" can be an important factor in the computation of depletion, especially percentage depletion. The fact that the properties are located in a foreign country will not deny depletion to a domestic corporation.

"The property" was not defined in the 1939 Code, and, because there are many types of property interests and there may be several mineral deposits in one lease, this led to considerable controversy and litigation.

Section 614 of the 1954 Code provides the following definition:

"For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

The heart of the definition is separateness. Separate interest! Separate deposit! Separate tract or parcel!

Separate interest: Whether there is a separate interest may depend on the kind of interest, the time it was acquired, from whom it was acquired, and/or the geographical location of the tracts or parcels of land. Also, where a taxpayer's interest is related to the proceeds of production, he may have as many separate mineral interests as there are conveyances to him.

The Internal Revenue Service has long held the view that, generally, each interest is a separate property, unless the taxpayer acquires the same kind of

interest, at the same time, from the same assignor, in tracts or parcels of land which are geographically contiguous. Thus where two interests are involved all four tests must be met if they are to be treated as one property.

Kinds of interest

Each kind of depletable interest is a separate property. The various kinds are: fee simple, royalty or overriding royalty, working (operating) rights, net-profits interest, and carried interest. Some of these interests are usually found in connection with the oil industry, but they can be adapted to the mining industry.

Fee simple interest: In the United States the ownership of land embraces both surface and subsurface rights in a clearly-defined tract, and the subsurface rights include the minerals in and under the tract. Thus, if a person owns a tract of land including the subsurface rights, he has a fee simple interest in it.

The mineral rights may be wholly or partially separated from the surface rights, and it is these mineral rights, or minerals as they are usually called, with which depletion is concerned and in which there are the different kinds of interests discussed hereafter.

Royalty or overriding royalty interest: A royalty interest is one which entitles its owner to a specified fraction, in kind or in value, of the total production from the property without his being burdened with any of the expense of development and operation.

An "overriding royalty" is one created from the working interest (explained below), and of course cannot be greater than the working interest. On the other hand, a "royalty" is created from the fee simple interest. Except for this difference they are the same.

Working interest: The working interest is the interest, *minus* the royalty payable to the lessor, in the minerals in place that is burdened with the cost of development and operation. This interest is created when the owner of the minerals grants a lease under which the lessee agrees to develop and operate the property, and, therefore, the lessee is the owner of the working interest. Because he may need capital or for other reasons, the lessee may divide his working interest with others or he may carve it up into other kinds of interests.

Net-profits interest: A net-profits interest is an interest in the minerals in place representing a share of gross production measured by the operator's net profits from the operation of the property. That is, it usually represents a specified fraction of such net profit. It is similar to an overriding royalty in that it is created from the working interest and has a comparable life, but dissimilar in that it is burdened with expenses.

The owner of the net-profits interest, of course, receives nothing if there is no net profit, and is not liable for any share of a net loss. However, any accumulated net losses must be offset by future profits before he is entitled to receive any income. This means that he bears expenses only to the extent of his share of income and no more.

The instrument creating the interest should carefully set forth definitions for such terms as operating expenses, depreciation, etc. and prescribe accounting procedures to be followed. Also, if the parties intend to create a depletable interest, care must be taken to prevent the net-profits interest from being construed as merely a contractual consideration for an assignment of property, rather than an interest in gross production.

Carried interest: A carried interest is one in which two or more co-owners of a working interest agree that one of the parties will advance all or some part of the development costs on behalf of the other (s) and will look only to their share of future production for recovery of such advances. The person making the advances is the "carrying party," and the person for whom costs are advanced is the "carried party." This kind of interest is not often encountered in the mining industry.

Separate tract or parcel of land: A separate tract or parcel of land exists where two or more areas are separated geographically, are connected geographically but were acquired from different assignors or at different times, or are not contiguous. For example, in one case a taxpayer acquired, in a single conveyance, a lease of four lots. Two of the lots were contiguous and two touched only at a corner. It was held that the contiguous lots were a single property, but the other two were separate properties. Also, where one tract of land has several deposits of ore existing at varying levels, it appears that each deposit may be treated as a separate property.

Aggregation of mineral interests: Even though there may be two or more separate mineral interests under the above definition, there are times when it is not practical to treat them as separate interests. For example, it is not economically sound to try to mine coal or sand and gravel within the boundaries of a single tract, if the tract does not contain the whole deposit. Consequently the taxpayer often encountered difficulty with the Internal Revenue Service whenever he attempted to treat several mineral interests as one property. Some of these attempts were successful, however, and some taxpayers have been permitted to treat several properties as one.

Operating mineral interests: It is perhaps for this reason that Section 614(b) was adopted. It provides

that if a taxpayer owns two or more separate *operating mineral* interests constituting part or all of an *operating unit,* he may elect to aggregate and treat as one property any two or more of such interests, except that only one aggregation may be formed in each operating unit.

An operating mineral interest is one in respect of which the production costs of the mineral are required to be taken into account for the purpose of computing the 50%-of-taxable-income limitation on percentage depletion, or would be so required if the mine or other mineral deposit was in the production stage. Thus, for example, a royalty interest is not an operating mineral interest.

In general, the term operating unit applies to an aggregation only of interests which may conveniently and economically be operated together as a single working unit. Thus all separate operating mineral interests which actually constitute part or all of an operating unit may be aggregated, even though such interests may not all lie in the same tract or parcel or in contiguous tracts or parcels. But geographically widespread interests may not be aggregated merely because one set of books is kept or because the products of such interests are processed at the same treatment plant.

The Senate Finance Committee report on Section 614 gives several illustrations of the operation of Section 614 (b).

The aggregation of mineral interests presents another area of flexibility in the computation of depletion, and is one in which careful study and judgment may produce substantial tax benefits. Of course, the goal is to obtain a greater depletion deduction, and though an aggregation of interests may give rise to greater gross income, the effect on taxable income must not be overlooked. For if some of the interests are now producing losses, or are expected to produce losses, the 50% of taxable income limitation may arise from the aggregation, and depletion would be less than before.

Taxable income from the property

As was previously pointed out, percentage depletion is limited to 50% of taxable income from the property. Therefore, the computation of taxable income for this purpose can be very important.

Computation of taxable income: Taxable income, as used here, means the gross income from the property *less* allowable deductions attributable to such property. Allowable deductions include those attributable to the ordinary treatment processes, overhead and operating expenses, and development costs which may properly be expensed, but do not include depletion. For a taxpayer owning an interest not burdened by production costs, such as a royalty or net-profits interest, gross income and taxable income therefrom will usually be the same.

It must be kept in mind that we are speaking here of taxable income from *each mineral interest.* Consequently, any deduction which is not applicable to mineral extraction is not required to be deducted in arriving at taxable income. For example, it has been held that charitable contributions need not be deducted.

The usual items which are required to be deducted, to the extent they relate to the property, consist of operating expenses, overhead, depreciation, and losses. Other items which have been ruled deductible are:

1. Interest on bonds, and amortization of bond discount and expense.
2. Bad debts, dues, assessments, attorneys' fees, capital stock taxes, and interest on money borrowed for development.
3. Damage claims of employees injured in prior years while working on taxpayer's mineral property.
4. Interest paid on prior years' federal income-tax deficiencies (taxpayer's only activity was oil and gas production).
5. Interest paid on money borrowed to purchase a producing oil and gas property.
6. Depreciation on lease equipment.
7. Back wages paid under a National Labor Relations Board settlement.
8. Officers' salaries, interest expenses, and office expenses.
9. State income, franchise, real estate, personal property, unemployment, and miscellaneous taxes and federal social security and capital stock taxes.
10. Foreign income taxes.

Some of these deductions, such as interest on prior years' taxes, constitute more or less unexpected deductions arising from prior years' transactions, which may have an adverse effect on current year's taxable income. This effect may be offset to some extent by the use of separate properties for depletion since, in some instances, the deductions may be attributable to nonproducing properties. Furthermore, deductions not subject to attribution will be allocated among the separate properties with, perhaps, less chance of bringing the 50%-of-taxable-income limitation into play than if there was only one property.

Credits and exemptions: Under the 1939 Code certain credits and exemptions, such as the personal exemption and dividends-received credit, were deducted from net income to arrive at the amount subject to tax. Under the 1954 Code these exemptions and credits are classified as deductions in arriving at taxable income on the tax return. However, these items are not to be treated as deductions in arriving at taxable income from the property.

Taxes and carrying charges: Under Section 266 the taxpayer may elect to capitalize certain taxes and

carrying charges, and if he does so, they will not be deducted in determining taxable income. Since this election is not binding from year to year and is rather flexible, it may be advantageous with respect to nonproductive properties. That is, no benefit would accrue from deducting these expenditures, due to lack of income, whereas capitalization would increase the basis of the property, thereby resulting in greater cost depletion and reduced gain on disposal of the property. This advantage may be mitigated, however, by the net operating loss carryover provisions.

Mine exploration expenditures: Expenditures made during the taxable year to ascertain the existence, location, extent, or quality of an ore deposit or other minerals constitute exploration expenditures, providing they are paid or incurred prior to the beginning of the development stage of the mine. The Regulations indicate that the development stage begins when it has been established that the ore or minerals exist in commercially marketable quantities.

Exploration expenditures do not include those which are specifically allowed as a deduction under some other section of the Code — for example, taxes. Also, they do not include those made for depreciable property. However, if such property is used in exploration, the depreciation thereon would be includible.

These expenditures, which at first glance might appear to be capitalizable, are subject to special rules.

Section 615 (a), effective for years beginning after December 31, 1953, provides that, initially, exploration expenditures up to $100,000 are deductible in the taxable year they are paid or incurred. This $100,000 limitation applies to the total of all such expenditures for the taxable year, and is not, for example, an amount allowable for each mine. Any excess over $100,000 must be capitalized into the cost of the particular mine involved, and thus becomes a part of the basis subject to depletion. This section replaced Section 23 (ff) of the 1939 Code, which provided a $75,000 limitation.

Section 615 (b) permits the taxpayer to elect to treat as deferred expenses any portion of exploration expenditures up to $100,000. Thus a taxpayer has an option either to deduct or defer all or any part of such expenditures.

Deferred expenses are not included as part of the adjusted basis of the mine or deposit for the purpose of computing cost depletion, but they are includible in the basis for all other purposes. Also, the basis is not reduced by excessive amortization of deferred expenses without tax benefit.

The election is binding only for the taxable year in which it is made. However, even though the taxpayer has a new election each year, Section 615 (c) limits it to four years. That is, after the taxpayer has paid or incurred exploration expenditures in four different years Section 615 can no longer be applied, and all such expenditures paid or incurred after the fourth year must be capitalized and become part of the basis subject to cost depletion. The four years may not necessarily be consecutive, because there may be years in which no exploration expenditures were paid or incurred. In determining whether the four years have elapsed, the taxpayer may have to tack on the years in which a transferor or predecessor applied Section 615. This happens when mineral property is acquired in any one of the various transactions that require the transferee to use the same basis as the transferor, or where Section 381 (c) (10), which may require the carryover of the election in certain corporate acquisitions, applies.

The purchaser of a mineral property, in applying the four-year limitation, may disregard any deduction taken or election exercised by the seller.

Exploration expenditures are, of course, incurred at a time when there is no income from the mineral property. Consequently, if the taxpayer does not have other income to offset these expenditures, it may be advantageous to exercise the election to defer. This is so because, since there is already a loss, no tax benefit would obtain from taking a deduction. Deferral would increase the basis of the property and give the taxpayer a deduction against future income. Thus, if the taxpayer decides to dispose of the property, he would have less taxable gain; if he decides to operate the property, he would have less future taxable income.

It must be kept in mind, however, that, even though the taxpayer has a loss in the year of expenditure, the net operating loss carryback provisions may permit an offset against prior income. Furthermore, deferral will reduce future taxable income from the property which, because of the 50%-of-taxable-income limitation, could have an adverse effect on depletion. These things may mitigate, to some extent, the advantages of deferral.

Mine development expenditures: Under earlier laws all development expenditures in excess of receipts from minerals sold were capitalized up to the time the mine reached the developed or producing stage. A mine is considered to have reached the developed stage when its intended annual output or capacity can be maintained. Normal output or capacity may be determined from various factors, such as the capacity of the plant, available market, transportation facilities, and opening to the mine.

After the developed stage is reached excessive expenditures may not be capitalized, unless it can be shown that they contribute to increased output or capacity. If they merely keep the mine developed up to normal capacity or to a point where normal output can be maintained, they must be expensed. Where excessive expenditures incurred during the producing

stage are properly capitalizable, they may be allocated to a definite period or deducted ratably as the ore benefited by the expenditure is sold. Where this is not feasible, they should be added to the basis subject to cost depletion. For example, in a metal mine where an aggressive development campaign is carried on resulting in a constantly-increasing quantity of developed and blocked-out ore, there is a constant addition to capital.

Section 616, which is the same as Section 23 (cc) of the 1939 Code, provides in subsection (a) that all expenditures paid or incurred by a taxpayer during the taxable year for the development of a mine or other natural deposit are deductible, provided they are paid or incurred after the development stage begins. These expenditures are deductible in both the development and production stages.

Under Section 616 (b) a taxpayer can elect to treat as deferred expenses these expenditures, which are normally deductible in full, to the extent they *exceed* the net receipts during the taxable year from the ores or minerals produced from the mine or deposit involved. It bears emphasizing that the election applies only to the *excess* expenditures, and those not in excess of net receipts must be deducted in full.

The statements made previously in connection with mine exploration expenditures concerning the following items are equally applicable to development expenditures:

1. Deductions specifically allowed under other sections of the Code, such as taxes.
2. Depreciable property and depreciation thereon.
3. Addition of deferred expenses to basis.
4. Excessive amortization of deferred expenses without tax benefit.
5. Years for which election is binding.
6. Effect on purchaser of a mineral property of election exercised by seller.

Expensing of machinery and equipment: Every accountant knows that an electric locomotive, mine cars, and steel rails should be capitalized and depreciated. However, there is an important exception in the mining industry. Expenditures for machinery and equipment bought for the sole purpose of maintaining normal production may be deducted in the year of purchase and installation.

Village operations: Generally, any gain realized on village operations will not be included in mining income. However, a loss from such operations must be deducted in arriving at taxable income from the property.

Carryover of election to successor: If a corporation acquires a mineral property in a tax-free liquidation of a subsidiary or other reorganization specified in Section 381, and the transferor corporation had made an election under Section 616, such election carries over to the acquiring corporation and it must continue the amortization.

The closing remarks made with respect to exploration expenditures also seem equally applicable to development expenditures.

Allocation of indirect expenses: A taxpayer engaged in the operation of more than one mineral property and/or other activities as well must allocate indirect expenses. Indirect expenses are those items of overhead or general operating expenses which cannot be directly attributed to a particular property or activity. It is important to recognize the distinction between attribution and allocation, and to make certain that all expenses subject to attribution are so treated. Those expenses that are properly attributed to a particular property or activity should escape allocation controversy with the Internal Revenue Service.

If the taxpayer is engaged in both mineral activities and some other activity, such as manufacturing, the indirect expenses must first be allocated between them. The Regulations indicate that the allocation is made on the basis of direct operating expenses attributable to each activity. This allocation should be very carefully made so that the mining activity will not be burdened with more than its proper share of the costs.

Having arrived at the portion applicable to mineral activities, the second step is to allocate it to processing, nonproducing properties, and producing properties, since it is only the portion applicable to producing properties that enters into the computation of depletion. This allocation may also be made on the basis of direct operating expenses applicable to each operation.

The third step is to allocate the portion applicable to production among the various producing properties. This allocation may be made on the basis of relative production, measured in either units or dollars.

It is of the utmost importance to remember that the methods of allocation specified in the Regulations are not rigid rules; they are methods which are generally acceptable. Thus, the taxpayer should be permitted to make his allocations on any basis that is reasonable in his circumstances and is consistently applied from year to year. ☆

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TAX CONSEQUENCES OF

Corporate organization and distributions

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Changes brought by the final Regulations covering corporate organization and distributions

Now that the Sub-Chapter C Regulations have been through the mill, recommendations made, proposed Regulations hashed over, we have the official and effective draft. As finally promulgated these new Regs. give us few major surprises, but a great many small points of critical importance to the tax practitioner concerned with that particular question. In the analyses of these final Regs. which are printed here a number of accountants and lawyers more than usually familiar with Sub-Chapter C point out the danger spots to look for when you are planning and executing programs to minimize taxes in connection with corporate organizations, liquidations, changes, and distributions. Readers are reminded that Sub-Chapter C itself was analyzed by many of these same authors in our September 1954 issue. Those readers desiring extensive detail or background may find it useful to read the following comments in conjunction with the earlier material.

Gaps in the Code filled by new Regulations covering distributions to stockholders

by JOHN L. PALMER

THE PURPOSE of this analysis is neither to restate or paraphrase the selected Regulations nor to dwell on their merits or shortcomings. Rather, an attempt is made to illustrate the statutory gaps which they fill and the basis therefor.

Section 1.301

Code Section 301 deals solely with amounts paid by a corporation to its shareholders. Although it is implicit that the section does not apply to any distributions made to a shareholder in some other capacity, such as employee, creditor, etc., this limitation is not flatly stated in the Code itself. Section 1.301-1 (c), however, clearly commits itself to the proposition that Section 301 is inapplicable "unless the amount is paid to the shareholder *in his capacity as such*." Although it is still too early to predict how religiously the Commissioner will feel himself bound by the above restriction, it may prove to be an important provision.

For example, will the Commissioner now forsake the constructive dividend approach which was rejected in *Joseph* (*R. Schmitt v. Commissioner*, CA-8, 1954) 208 F.2d 819? The Court of Appeals reversed the Tax Court, which had held that payments made by a corporation to a retiring shareholder constituted dividends to the continuing shareholders who instigated the redemption. It is to be hoped that this much-criticized approach of taxing to one shareholder corporate distributions made to another, is within the intended scope of Section 1.301-1 (c). However, it would seem clear that this construction would not bar the Commissioner from taxing as dividends distributions made to "creditors" of a "thin corporation."

Another clarification of statutory language is contained in Section 1.301-1 (b), dealing with the valuation date of property distributed to shareholders. This subsection, by definition and example, clearly provides that the date of the distribution by the corporation and not the date of actual receipt by the shareholder-recipient shall be the valuation date for computing fair market value of the distribution. Although the normal time span between distribution and receipt will usually be short, in the case of volatile tangible property or securities, a delay between distribution and receipt could be an important one. Rightly or wrongly, the Regulation states a position. Its lesson for the practitioner is clear. There is nothing to lose by diligently getting volatile property into the hands of shareholders immediately upon distribution. This is especially true where the property is to be promptly sold by the shareholder.

The term "earnings and profits" is a

cornerstone of Section 301. While subchapter C does not define the term, Section 316, as supplemented by Section 312, prescribes certain adjustments to earnings and profits when a corporation receives, sells, or distributes property. The proposed Regulations under Section 316 abortively attempted to superimpose upon subchapter C, including the so-called "Hirshon and Godley Rule." Fortunately, the Commissioner bowed to a storm of protest and withdrew that portion of Regulations Section 1.316-1 (a) 2. Although this facet of the corporate distributions problem is covered in a discussion of the shareholder's position under Section 316, the importance of the concept should not be ignored when dealing with a Section 301 problem.

Section 1.304

Section 304 clearly and perhaps finally carries the "substance v. form" doctrine to its ultimate conclusion with respect to certain redemptions of stock in the case of "brother-sister corporations." Since 1950, similar provisions regarding parent subsidiary "sales" have been in effect. [Section 115 (g) (2), 1939 Code.] Generally speaking, the added effect of Section 304 is to characterize as redemptions distributions which are cast in the form of sales but which, because of interlocking stockholdings, are equivalent to redemptions.

In addition to continuing Section 115 (g) (2), Section 304 introduces certain mathematical tests or "ground rules" regarding purchases of stock by a "brother" corporation from certain control shareholders of its "sister" corporation. If a purchase brings Section 304 into play, then the tax treatment accorded to the selling shareholder is governed by Sections 302 or 303.

Because its mathematical tests are positively stated in the statute itself, the Regulation concerns itself largely with examples clarifying and explaining the tests imposed by the Code section. So far at least, no gaps have appeared which would require extended Treasury interpretation.

With one simplifying change, Section 307 carries over the 1939 Code rules regarding apportionment of basis on stock acquired as a stock dividend, or pursuant to a stock split or other nontaxable exchange. The new Regulations adopt the time-tested rules formerly contained in Reg. 118, Sections 39.113 (a) (19)-1 and 39.113 (a)-(12)-1.

The sole substantive addition to the Code and Regulations eliminates the necessity of making *de minimus* basis allocations between stock and stock rights issued with respect thereto. If the fair market value of the rights at the date of distribution is *less than* 15 per cent of the fair market value of the stock upon which the distribution is made, then the taxpayer may at his option attribute a basis of zero to the rights, thus retaining his old basis for the stock. If the fair market value of the right is 15 per cent or more of the fair market value of the source stock (*or* even in cases where the value is under 15 per cent, if the taxpayer so elects), an apportionment of basis is required under the general rules described above.

As in the case of Section 304, the statutory provisions of Section 307 are mathematical in nature and the Regulations indulge in a minimum of controversial construction. Further, the Code section dignifies the Regulations with the now familiar language "under Regulations prescribed by the Secretary or his delegate."

Other than examples, the only interpretative provision of the Regulation appears to be the statement of Section 1.307-1 (2) which provides that fair market value proportions shall be computed "as of the date of distribution" and not as of the record date. This is in accord with existing Regulations and is certainly not controversial.

The only other provision which amplifies the statute is Section 1.307-2, which prescribes rules for making the election regarding allocation. This section requires any shareholder who has elected allocation to retain a copy of the election and a copy of the return with which it was filed. Presumably these must be retained until the stock is disposed of *and* the statute has run on the return covering the year of disposition.

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Some problems still remaining under Regulations on stock redemptions, dividends

by RICHARD L. GREENE

Sections 302, 303, and 305 of the 1954 Code deal with stock redemption and dividends. Each section will be discussed separately.

Stock redemptions (Sec. 302)

The writer commented earlier (September 1954 issue of Journal of Taxation) on the victory of the Treasury in persuading Congress to enact Section 302 (distributions in redemption of stock) of the Code a very restrictive rule. It was said then that tax men earnestly hoped that Treasury would adopt sensible and reasonable Regulations construing the Congressional intent to revert to and incorporate the "existing law" and "currently employed" tests in the application of Section 302 (b) (1), providing that this section does not apply if the redemption is not substantially equivalent to a dividend. We regret to report not only that that hope has been shattered, but also that the Regulations on Section 302 have in several major areas gone beyond the Congressional intent in applying a super-charge to a statutory provisions already loaded with dynamite.

It will be recalled that the American Bar Association, and various other bar associations and interested groups, filed appropriate objections to the proposed Section 302 Regulations, and some of the filed objections and suggestions evidently received favorable consideration. We find, however, that the final Regulations preserved what was considered by a great many tax men to be serious defects.

An exhaustive analysis of these provisions is not feasible in view of the space limitations involved in this Department's comprehensive survey of the entire subchapter C Regulations. The Section 302 Regulations are extensive and involved, and necessarily so in view of the nice questions presented in the statute itself. Accordingly, these comments will be limited to some of the controversial or

objectionable highlights of the Regulations.

Various groups had expressed their concern as to the creditor provisions of the termination-of-interest rule contained in Section 1.302-4 (d). It seems that Treasury was not satisfied with the 10-year forward freeze created by the statute, which effectively prevents a terminating shareholder from re-acquiring any interest in the corporation, other than as a creditor if he is the victim of the constructive ownership rule. The Regulations go further and seek to deny creditor status to obligations which may be discharged "by payments, the amount or certainty of which are dependent upon the earnings of the corporation." This provision, we think, will preclude many loan provisions which are recognized as standard commercial security devices. For instance, it is conceivable that a request made by a corporate debtor nine years after a redemption for an extension of a note installment on the ground of insufficient earnings might be construed so as to make the "amount, regularity, or certainty" of the obligation dependent upon earnings, and hence, the noteholder is not a creditor and thus liable to the disastrous tax on a "dividend" distributed nine years before. So also, provisions for acceleration of payments as the debtor's earnings reach a certain level, as contained in many existing commercial loan agreements, might deny creditor status to this type of arrangement.

We are concerned also as to the potential danger to a creditor (an ex-stockholder) who, having been converted into a stockholder again by operation of law, court order or other involuntary conversion, may thereby run afoul of the provisions of Section 1.302-4 (e) of the Regulations. Such a creditor who becomes a stockholder, through no action on his part but by an involuntary conversion situation, may find a Revenue Agent contending he has violated the 10-year freeze rule and hence, is subject to a huge tax on a "dividend" redemption made many years before.

Section 1.302-2 (b), which covers the general rule of dividend equivalence formerly in Section 115 (g) (1), continues to reflect a point considered an irritating error in the proposed Regulations by at least two bar associations. They lay down a sweeping rule that "ordinarily" a *pro rata* redemption of part of the stock is a dividend "and regardless of whether all stock being redeemed was acquired by the stockholders . . . by purchase or otherwise." (Such facts have not been disregarded by the courts in the interpretation of Section 115 (g) of the 1939 Code.) But more important, this provision, plus the succeeding sentence to the effect that all *pro rata* distributions of part of the stock "generally" will be treated as dividends, seem to create by administrative fiat practically a presumption or *prima facie* case merely because the disposition was *pro rata*.

Under the litigated cases involving Section 115 (g) (1), the *pro rata* feature of the redemption was only one of numerous applicable factors in determining whether the redemption was equivalent to a dividend. The Senate Reports state the intent to incorporate existing law and the "currently employed" tests under Section 115 (g) (1), and these include particularly the presence or absence of a business purpose, dividend record, etc. It would have been helpful for the guidance of taxpayers and equally helpful to Internal Revenue representatives if the Regulations had set forth the major factors or tests "currently employed" in the determination. Instead, the Regulations stop at setting up a sweeping general rule of taxability, leaving the unwary taxpayer to the mercy of the Revenue Agent or perhaps a Tax Court judge.

We note also that Sections 302-1 (a) and 302-2 (b) would seek to apply the constructive-ownership rules to all redemptions, including those under Section 302 (b) (1) [those not equivalent to a dividend, which is based on Section 115 (g) (1)]. This was retained over the vigorous objection of the Chicago Bar Association, which argued persuasively that the Senate intent to incorporate existing law under Section 115 (g) (1) of the 1939 Code demonstrated the rules for constructive ownership under Section 318 were not intended to apply to Section 302 (b) (1). It is, of course, significant that the Commissioner had previously been unsuccessful in applying the constructive-ownership rules under Section 115 (g) (1) (*Ira F. Searle Estate* (1950), 9 TCM 957; *Nugent-Head Trust* (1951), 17 TC 817), and his proposed Regulations regarding constructive ownership under Section 115 (g) were proposed but never enacted.

Redemptions to pay death taxes and expenses

Section 303, a remedial statute, was designed to eliminate the statutory flaws inherent in Section 115 (g) (3), and the strict administrative interpretation by the Commissioner that often compelled executors to act at their peril in applying the section. The defects were largely eliminated and the application of the statute greatly expanded by Section 303 of the 1954 Code. The new Section 1.303 Regulations, by and large, follow the statutory pattern in a competent manner and answer most of the problems not specified in the statute. These are not numerous since the statutory provision had already eliminated most of the bugs from the old Section 115 (g) (3).

The time problem on the redemption is adequately explained in the Regulations, so that the redemption may be postponed until any time before the expiration of 60 days after the Tax Court decision becomes final. The Regulations properly emphasized that this extension refers only to a bona fide contest in the Tax Court and not a proceeding initiated solely for the purpose of extending the period of application under Section 303 [Section 1.302 (e)].

The Regulations [Section 1.302 (f)] also note the occasionally overlooked feature of Section 303 that if the other conditions are satisfied, the redemption may be of stock included in the gross estate, which has been distributed to an heir, legatee, surviving joint tenant, etc. It may even apply to stock transferred to a donee in contemplation of death. It does not apply, however, to stock redeemed from a stockholder who acquired it by gift or purchase from some one to whom the stock passed from decedent.

It is also gratifying that the regulations [Section 1.303 (d)] have stressed and amplified the provision of Section 303 (c) of the Code, which is designed to permit the application of the section to stock having a substituted basis. This was a serious non-tax barrier to the old Section 115 (g) (3), in that a redemption of voting stock to pay death taxes would frequently result in loss of control of the corporation. The new provisions thus permit the application of the section to nonvoting stock redeemed, which was received in a tax-free reorganization

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after the death of decedent, thus preserving control in the decedent's family or estate. The Regulations note that this special provision covers also stock received in a Section 355 transaction (spin-off, etc.), in a Section 1036 transaction (non-taxable exchange of stock for stock of the same corporation), and a stock dividend under Section 305 (a) (*e.g.*, non-voting stock dividend on voting stock). It is likewise intriguing to note that the Regulations permit even Section 306 stock to be redeemed under Section 303.

Stock dividends—Section 305

Section 305 of the Code had already put to rest the doubts, confusion, and complexities that bubbled out of the minds of tax administrators and Supreme Court judges in the taxability of stock dividends. By a simple rule of law, it made nontaxable all stock dividends subject to relatively insignificant exceptions.

As anticipated, the Regulations concentrate mainly on the two exceptions: (1) where the stockholders may elect to take cash or property instead of the stock or rights, and (2) where the distribution is made in discharge of preference dividends of the current or preceding taxable year.

The American Bar Association had objected to the language in the proposed Regulations on Section 1.305-2 relating to the election of shareholders as to medium of payment, and this language has been clarified somewhat, although some problems may still arise. The Regulations do make it doubly clear that if *any* shareholder has the right to an election to take money or property in lieu of stock or rights, then *all* the shareholders may be given taxable-dividend treatment. But this treatment fortunately results only as to the portion of the distribution with respect to which the election applies.

The Regulations (Section 1.305-1) also clarify the point that Section 305 applies to a distribution made out of treasury stock. This is consistent with recent *Rev. Rul.* 55-746 (52 IRB 10, Dec. 27, 1955), which ruled on the rather obvious fact that common stock received as a dividend on common stock (when preferred was also outstanding) is not Section 306 stock, even though distributed out of treasury stock.

The Regulations (Section 1.305-1) also properly note that the distribution must be of the stock or rights of the distributing company. Thus, it would not be possible to apply Section 305 to a distribution of stock of a subsidiary corporation, nor to stock issued to a creditor, nor to an employee as compensation, nor to a stockholder as a gift. See Sections 305 (c) (2) and (3) of the Code.

Distribution of assets in liquidation is big uncertainty in Regs. on liquidations

by JOHN S. PENNELL, J.D.

IN AGAIN LOOKING OVER our discussion on Sections 331,332, and 346 in the September 1954 issue, we find that we raised a number of questions then which we hoped would be answered in the final Regulations. Particularly as regards Section 346 (partial liquidations) we expressed a pious hope for answers or guideposts in the Regulations—when issued. The Regulations have been issued, supplying some answers, more guideposts, many blanks, and unfortunately some directions that appear to lead into difficulties.

As was to be expected, the Regulations under Section 331 (gain or loss to shareholders on partial liquidation) contain nothing startling. That section merely provides sale or exchange treatment if a liquidation, either complete or partial, exists, and there is little that the Regulations could add to the Code. Section 1.331-1 (c) does warn, if warning were needed, that if a liquidation is followed or preceded by the transfer to another corporation of all or part of the assets of the liquidating corporation, the liquidation may have the effect of the distribution of a dividend.

Startling addition to Sec. 346

The Regulations under Section 346, however, do add to the Code, in some respects in a rather startling manner. Unfortunately they make no attempt to settle the difficult question of what, if anything, short of a corporate contraction will qualify as a partial liquidation. The language in this respect merely follows that of the Senate Committee Report which indicates that "primarily" a partial liquidation involves the concept of corporate contraction. Although this language implies a secondary meaning, the Regulations give no hint of what it may be.

The primary concern of the Regulations is in the area dealing with the distribution of the assets of (or the proceeds of sale of assets of) an active business conducted for five years. By reference to Section 1.355-1 (c) of the Regulations relating to active business for spin-off purposes, answers are given to some of the questions that arise in this area. The answers will not apply to many situations, and where they do apply will not always be to the taxpayer's liking, but they will help in many cases, and are not as restrictive as had been anticipated in some quarters.

Restrictions on inventory

Sections 1.346-1 (b) (iii) and (iv) place restrictions on the distribution in partial liquidation of inventory or the proceeds of its sale. Inventory itself may be distributed in partial liquidation only if it is substantially the same kind and in substantially the same quantities as regularly on hand during the previous five years. The purpose is apparently to prevent loading of the inventory by purchases with funds from the retained business.

Proceeds from the sale of inventory *in bulk* in the course of termination of the business may be distributed in partial liquidation. The implication is that if the inventory were sold in the ordinary course of business, the proceeds could not be distributed in partial liquidation. In either case the profit on the sale would be taxed to the corporation, and no reason is readily apparent for a different treatment on the distribution. (See discussion in Pennell, "Divisive Reorganizations and Corporate Contractions", *Taxes*, December, 1955, p. 924 at p. 936.)

One further provision of the Regulations on partial liquidation deserves comment. A sentence in Section 1.346-1 (a) provides that a distribution to which Section 355 (concerning divisive reorganizations) applies will not qualify as a partial liquidation. This is apparently an attempt to prevent a dis-

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tribution of stock from qualifying as a partial liquidation if it would not qualify as a spin-off. Thus, distribution of the assets of a business operated as a division could qualify as a partial liquidation even though the business were operated only four years. But if that business operated as a subsidiary, the stock could not be distributed in a spin-off and apparently could not be distributed in a partial liquidation.

The Regulations under Section 332 (concerning complete liquidations of subsidiaries) need little comment except for two points, both of which confirm the interpretation placed on Section 332 by most tax counsel. Section 1.332-2 (b) emphasizes that nonrecognition of gain or loss applies only if the parent corporation receives at least part payment on its stock. If it does not, then the provisions on loss from worthless securities apply. Section 1.332-7, dealing with the effect on a subsidiary of payment of a debt to the parent with appreciated assets in connection with a liquidation, makes clear that gain or loss to the parent on satisfaction of the debt will be recognized.

A ray of hope appears in final Regs. on collapsible corporations (Sec. 341)

by JACKSON L. BOUGHNER, LL.B, CPA

SECTION 341, dealing with collapsible corporations, was considerably changed by the Internal Revenue Code of 1954 and is now even more of a trap for the unwary than it was before. Included now in the type of assets involved are Section 1231 assets, more commonly known as depreciable property and land used in a trade or business. On the face of it, if an investor purchases an office and places it in a corporation, he has formed a collapsible corporation. In the event an unexpected opportunity to sell the stock arises less than three years after he acquired it, the gain would, presumptively, be ordinary income.

Intent is important

However, a ray of hope is found in Section 1.341-2 (a) (3) of the final Regulations. The statute defines a collapsible corporation as one which was formed or availed of principally for the manufacture, etc. of property, with a veiw to a sale or exchange of the stock, etc. and the realization by the shareholders of the gain. In the event there has been no *intent* to sell the property for such purposes up to the time of the actual sale, the Regulations state that the corporation will not be deemed a collapsible corporation. If we turn to Section 1.341-5 (d) we see in Example 3 the type of situation the Commissioner is referring to. In that case, the principal stockholder, who was the president of the company and active in the conduct of its business, retired from all business activities as a result of illness. He sold his stock before realizing a substantial part of the income from a rental building which the corporation had constructed. The Regulations state that the corporation will not be considered a collapsible corporation.

Almost any newly-formed corporation may find itself in a position where it wishes to sell its assets at a profit, without being considered a collapsible corporation. There should be no written or oral indication of any type that it was ever intended that such action would be taken. The minutes, correspondence, and all other documentary evidence should indicate that the corporation was formed for the sole purpose of engaging in its business for an indefinite period of time. If, then, before three years have elapsed from the acquisition or construction of the property which will produce a gain an opportunity for a sale arises, it would be extremely helpful if there were no indication in the record that the sale was being made solely to realize capital-gains income. It might not be possible to arrange for the principal stockholder to become sufficiently ill so that he has to retire from business, but, presumably, there would be less drastic reasons which would compel a sale. The situation is one which calls for careful planning at all times, lest a sale that suddenly arises from nowhere and is so attractive that it cannot be turned down prove to be completely unfavorable as a result of the application of the collapsible-corporation rules.

The 1954 Code set up a presumption in Section 341 (c), under which, if certain circumstances are present, the collapsible corporation rules will automatically apply. Section 1.341-3 (a) discusses this presumption, and subparagraph (b) contains an example of how it operates. The corporation involved there has cash and investments of $850,000; a building with a basis of $600,000 and a fair market value of $750,000; and rents receivable of $15,000. In applying the 50% rule, the cash and investments must be eliminated, leaving only the building and the rents receivable, of which the building is obviously over 50%. Since the fair market value of the building ($750,000) is over 125% of its basis ($600,000) the corporation is a collapsible corporation.

Let us assume that, being aware of these provisions, the corporation, some time prior to liquidation, uses the $850,000 of cash and investments to acquire another building. This new building will be a Section 341 asset and will not change the application of the 50% rule. However, the total Section 341 assets now have a fair market value of $1,600,000, which is only 110% of their basis of $1,450,000. The presumption will, therefore, not apply.

Congress was very careful to state, in adopting this subsection, that even if the presumption was not met, the corporation could still be considered a collapsible corporation. It would seem though, that it would not hurt in a situation of this kind to see to it that the presumption is not applicable.

Only long-term-gain-deals affected

Under Section 1.341-4 of the Regulations, the collapsible-corporation provisions are not applicable unless the gain is long-term. Although this is not much solace in the majority of cases, it might prove helpful in some instances. Assuming that the taxpayer has a large capital loss which he otherwise cannot use, his tax burden will be much less if he realizes a short-term capital gain from the sale of the stock of a collapsible corporation than if he receives ordinary income.

It is possible that under certain circumstances relief may be achieved by bringing a corporation under the gen-

eral principles of Example 4 in Regulations 1.341-5 (d). In that example a corporation formed in 1948 had distributed its earnings from motion pictures as dividends every year. It completed a picture in 1954, and on January 2, 1955, before the picture had been rented, the sole stockholder sold all of his stock at a gain. The Regulations point out that under such circumstances the corporation would not be considered a collapsible one because the amount of income realized from the sale of the last motion picture was not substantial as compared with the distributed income realized from all other pictures produced. Apparently, if the corporation had not distributed its prior years' earnings, this rule would not apply.

Many taxpayers have been worried because of the possibility that a corporation would be considered a collapsible one if it has a large inventory which is worth substantially in excess of its basis. However, if the corporation has been paying dividends in previous years, it would seem possible, under this example, to compare the income resulting from the sale of this inventory with the total income realized and distributed in prior years from normal operations, and show that the collapsible corporation provisions would not apply.

Sections 346, 351, 355

Thomas S. Sly, of the law firm of LeForgee, Samuels & Miller, Decatur, Illinois, commented on Code Sections 346, 351, and 355 in the September 1954 issue. Our perusal of the final Regulations on these sections indicate that some of the problems which he thought might be solved in the Regulations are still wide open.

Sections 346 and 351 present few problems and Regulations in general follow the law. As to Section 355 however, which replaces the old spin-off provisions, the Commissioner has left several points in doubt. He does furnish us with a number of examples of what will constitute a separate trade or business. The mere holding for investment purposes of stock is not considered a separate business, nor is the ownership and operation of land or buildings which are used and occupied by the owner in the operation of a trade or business. Most tax men anticipated that this would be the ruling, but they did expect a little light to be cast on the question whether an investment portfolio could be transferred to a separate corporation, or the business real estate so transferred, thereby permitting, after the passage of five years, a spin-off of the stock of the subsidiary. Since the general rule is that the operation and management of a building constitutes a trade or business, a provision in the Regulations clarifying this issue would not have conflicted with present case law.

One of the principal reasons for accomplishing a spin-off of a segment of a business is to put the owners in a position to sell the stock so acquired and to realize cash at capital-gains rates. So long as this segment is in the original corporation, any profit inures to that corporation and can be distributed only as a dividend taxable at ordinary rates. Regulations 1.355-2 deal at length with the situation where the spin-off has been effected primarily for the purpose of selling the stock or securities received. They point out that if there is an agreement in existence prior to the spin-off it will be treated as a distribution of earnings and profits.

We had occasion sometime ago to try to fit Section 355 into the following situation:

A Corporation owns 80% of the stock have been engaged in a separate trade or business for over five years, but A has not owned a full 80% of B during that of B Corporation. Both corporations entire period. A new corporation is formed, which we will call C Corporation, and A transfers its stock in B to this corporation and distributes C Corporation's stock to its shareholders.

An examination of the literal language of Section 355 indicates that this type of transaction should be tax-free. The active business requirement is met under Section 355 (b) (1) (A), as defined under Section 355 (G) (2) (A). The five-year period is met under Section 355 (b) (a) (1) (ii). We recently requested a ruling on this type of transaction and were turned down. The Commissioner apparently insists that Sections 355 (b) (2)) D) (i) and (ii) must be read together. He does not, however, comment on this situation in the final Regulations.

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Hirshon, Godley rule dropped in final Regs. on distributions in kind (Secs. 311, 12, 16, 17)

by **JOSEPH C. HODGES**

In the September 1954 issue, Joseph C. Hodges, manager of the Tax Department, National Cylinder Gas Company, Chicago, commented for us on Code Sections 311, 312, 316, and 317, dealing with distributions in kind. In the April 1955 issue, he pointed out several matters in the proposed Regulations which were worthy of note. He now reports that the final Regulations contain certain changes from the proposed Regulations which are important.

THE MOST IMPORTANT CHANGE between the final and the proposed Regulations on Subchapter C is that the Treasury is dropping the rule of the *Hirshon* and *Godley* cases, so much discussed in these pages. The wording of Regulations 1.316-1 (a) (2) and (3) is altered to conform the Regulations to the apparent intent of Congress. Under the proposed Regulations, a distribution in property was taxed to the recipient stockholder as a dividend to the extent of the property's fair market value even though the earnings and profits of the corporation were less than the fair market value of the property distributed. As changed, the final Regulations provide that the income to the stockholder shall be limited to the earnings and profits of the corporation. Thus a corporation which had earnings and profits of $8,000 makes a distribution of property which cost $6,000 but had a fair market value of $10,000. As a result of this distribution, the stockholder would report $8,000 as ordinary dividend income, the

amount of earnings and profits of the corporation. It should be noted that the corporation would reduce its earnings and profits by only $6,000, its cost of the property distributed.

Another change in the final Regulations as compared with the proposed Regulations deletes Regulation 1.317-2, which stated that if a corporation makes a distribution of property simultaneously with a reduction in par value of its capital stock, such distribution was to be treated as received in redemption of such stock. This deleted section of the Regulations was the incorporation in the proposed Regulations of Section 312 (e) of HR 8300, which was removed by the Senate Committee Report, such removal being accepted in Conference. This change, of course, takes away the certainty of the treatment of a reduction in par value of capital stock accompanied by a distribution of property and makes it necessary to consult Section 302 of the 1954 Code and Regulations before determining whether the transaction is a redemption or a sale or exchange.

The last change in the final Regulations deleted proposed Regulation 1.317-3, which provided that if a corporation sold its own treasury stock no gain or loss would be recognized. In other words, the proceeds of the sale of treasury stock would be treated the same as proceeds from the sale of previously unissued capital stock.

This omission in the final Regulations does not seem to be a very serious matter in view of the fact that Code Section 317 (b) states that "stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property whether or not the stock so acquired is cancelled, retired, or held as treasury stock."

Effect of reorganization on stock and security holders (Secs. 354 to 358)

by **MAX E. MEYER**

In the January, 1955, issue, Paul L. Freter discussed Code Sections 354 to 358. We asked Max E. Meyer, a partner in the law firm of Lord, Bissell & Brook and a member of the federal taxation committee of the Chicago Bar Association, to comment on the final Regulations under these sections. He has some interesting ideas on Section 355, commented on previously, which we particularly wish to bring to the attention of our readers.

THE FOLLOWING COMMENTS are directed towards the Regulations on Subpart B dealing with the effects on shareholders and security holders, except for Section 357 dealing with assumption of liability. These regulations are part of the final Regulations on Subchapter C, published in the *Federal Register*, December 3, 1955.

Exchanges of stock and securities (Section 354)

Section 354 (a), IRC, provides the general rule that while stock can be exchanged tax-free for stock in a reorganization, securities can be received tax-free only to the extent of the principal amount of securities surrendered, so that it becomes important to distinguish between the two. Nevertheless, neither the Code nor the Regulations define either term. It would seem that they should have been defined since in ordinary usage the term "securities" normally includes stock, whereas as used in Section 354, obviously it does not.

Section 354 (b) is an exception to the general rule in 354 (a). It limits the application of 354 (a) in divisive reorganization under Section 368 (a) (1) (D). It is designed to prevent the casting into the form of a tax-free reorganization a spin-off or split-off of part of the assets of a corporation which could not be accomplished tax-free under Section 355 because the requirements as to active businesses are not met. This is accomplished by requiring substantially all of the assets of the transferor to be transferred in order to qualify as a Section 368 (a) (1) (D) reorganization. The Regulations permit the retention by the transferor corporation of sufficient assets to satisfy existing liabilities incurred in the ordinary course of business before the reorganization, if such liabilities are not represented by securities.

Distribution of stock and securities of a controlled corporation. (Section 355)

Section 355, IRC, contains the rules on reorganizations which divide an existing corporation. A statement of the restrictive nature of this divisive-reorganization section is contained in the first paragraph of the Regulations as follows: "Section 355 does not apply to the division of a *single* business." In other words, only two distinctly separate businesses can be separated tax-free.

This section is intended to liberalize the requirements regarding divisive reorganizations; for example, the necessity of forming a useless subsidiary was eliminated. However, Congress made the requirements more restrictive in at least one respect. Presumably under prior law, a corporation could spin off stock of a less-than-80%-owned subsidiary, but this cannot be done under the new Code provisions. The Regulations, too, take a narrow view of the statutory language. Two of the sixteen examples of the Regulations might be mentioned particularly.

Example (12) states that a manufacturer of steel and steel products cannot spin off a coal mine used for the sole purpose of supplying the coal requirements of a steel business. The theory is that the coal mine is not a separate trade or business, since the activities are not themselves independently producing income. Presumably, this means the coal is not sold to the public for profit.

Example (16) provides that an automobile manufacturer cannot spin off an executives' dining room even though the executives are charged for their meals and a profit is derived from their operations. Such dining room is apparently held to be only part of the automobile business and not a separate business.

A number of the other examples deal with the situation where a company has one plant in one state and another plant in another state. It is held that the activities in each state constitute a trade or business. Query: What might the position of the Internal Revenue Service be if the two plants were merely in separate cities or were even on opposite sides of the same city?

The Code states that the mere fact that subsequent to the distribution the

stock or securities are sold or exchanged shall not be construed to mean that the transaction was used principally as a device for distributing earnings and profits, unless the sale or exchange was pursuant to an arrangement negotiated or agreed upon prior to the distribution. The Regulations questionably change this negative statement into a positive one to the effect that if there is such prior negotiation or agreement, such sale or exchange will be evidence that the transaction was used principally as a device for distributing earnings and profits. Also, it may be doubtful as to whether the proper interpretation of the word "negotiated" includes only a prior "discussion" by the buyer and seller where enforceable rights did not exist before the distribution. However, the Regulations indicate that there could be such an interpretation, stating that in cases where there have been discussions but no enforceable rights exist ". . . the question whether an arrangement was negotiated . . . shall be determined from all the facts and circumstances."

Where a corporation owns more than 80% of the stock of another corporation, assuming all the other requirements are met, it may keep part of the stock in excess of 80% and distribute only the balance, provided that it is established to the satisfaction of the Commissioner that the retention of any stock does not have tax avoidance as its principal purpose. An indication of the narrow view of the Internal Revenue Service is the statement in the Regulations to the effect that business reasons, as distinguished from a desire to distribute earnings and profits, *ordinarily* will require the distribution of all the stock and securities.

A distributing corporation may be one which itself is engaged in the active conduct of a trade or business or which has no assets other than stock or securities in controlled corporations, each of which is engaged in the active conduct of a trade or business. [Section 355 (b) (1)]. The Regulations provide [Section 1.355-4 (a) (2)] that in the second situation, a de minimis rule will be applied to the "no assets" requirement.

The requirements as to the active conduct of a trade or business for a five-year period prior to the distribution will not be met if the trade or business was acquired during such five-year period in a transaction in which gain or loss was recognized in whole or in part [Section 355 (b) (2) (C)]. The Senate Committee Report would seem to be in error in stating "where such trade or business was acquired in a *taxable* exchange, the period of time such trade or business was actively conducted by the predecessor may be used in determining whether the fifth period requirement is met." The Regulations do not bear out the Committee report but state:

". . . such trade or business must have been actively conducted for the five-year period ending on the date of distribution of the stock and securities of the controlled corporation the stock of which was distributed as provided in Section 355 (b) (2) (B). Furthermore, such trade or business must not have been acquired by either corporation during such five-year period unless it was acquired in a transaction in which gain or loss was not recognized [Section 355 (b) (2) (C)]. . . ."

Receipt of additional consideration. (Section 356)

One point should be mentioned in connection with the Regulations on Section 356. That section provides in part that if in connection with an exchange under Section 354, discussed above, the principal amount of securities received exceeds the principal amount of securities surrendered, gain shall be recognized to the extent of the fair market value of such excess, which is considered as "other property." Example (5) of Section 1.356-3 (b) of the Regulations states:

"E, an individual, exchanged a security in the principal amount of $1,000 for another security in the principal amount of $1,200 with a fair market value of $1,080. The fair market value of the excess principal amount, or $180, is treated as 'other property'."

The fair market value ($1,080) of the security received is 90% of its face ($1,200); the value of the principal amount equal to the principal amount surrendered ($1,000) is $900, and the fair market value of the excess amount ($200) is $180. Note that the value of the $200 excess principal amount is $180 and is taxable—not merely $80, the excess of the $1,080 fair market value of the security received over the $1,000 principal amount of the security surrendered.

Basis to distributees. (Section 358)

After first providing the general basic rules in connection with tax-free exchanges, Section 358 goes on to provide in subsection (b) that under Regulations prescribed by the Secretary or his delegate, the basis so determined shall be allocated among the properties permitted to be received without the recognition of gain or loss. In substance, the Regulations provide that a taxpayer must first determine with respect to what stock or securities previously held the new stock or securities are received. Then the basis of the stock or securities held before the transaction shall be allocated to the new stock or securities based on their respective fair market values. This may be illustrated by Example (3) in Section 1.358-2, which states:

". . . C, an individual, owns stock of Corporation Y with a basis of $5,000 and owns a security issued by Corporation Y in the principal amount of $5,000 with a basis of $5,000. In a transaction to which Section 354 is applicable, he exchanges the stock of Corporation Y for stock of Corporation Z with a stock of $6,000, and he exchanges the security of Corporation Y for stock of Corporation Z worth $1,500 and a security of Corporation Z in the principal amount of $4,500 worth $4,500. No gain is recognized to C on either exchange. The basis of the stock of Corporation Z received for the stock of Corporation Y is $5,000. The bases of the stock and security of Corporation Z received in exchange for the security of Corporation Y are $1,250 and $3,750, respectively."

The Regulations provide in addition that notwithstanding the above general rules,

". . . in any case in which a plan of recapitalization under Section 368 (a) (1) (E) provides that each holder of stock or securities of a particular class shall have an option to surrender some or none of such stock or securities in exchange for stock or securities, and a shareholder or security holder exchanges an identifiable part of his stock or securities, the basis of the part of the stock or securities retained shall remain unchanged and shall not be taken into account in determining the basis of the stock or securities received." Section 1.358-2 (a) (5).

Between December 11, 1954, when the proposed Regulations on Subchapter C were issued, and December 3, 1955, when the final Regulations were published in the *Federal Register*, a committee of outstanding tax lawyers worked with the Internal Revenue Service and the Treas-

ury Department in drafting the final Regulations. While there is always room for improvement, work on any project has to stop sometime, and it is generally thought that the final Regulations are about as good as could be done by anyone within any reasonable length of time. ☆

Final Regs. attempt to clear up problems in recognition of gain or loss (Secs. 336, 7, 8)

by **ROBERT H. KINDERMAN**

In September 1954, Robert H. Kinderman discussed Code Sections 336, 337, and 338. He was then with the Chicago law firm of Sidley, Austin, Burgess & Smith, but is now with Mead Johnson & Company of Evansville, Indiana. He commented on the proposed Regulations on these sections in the June 1955 issue and now brings us up to date on the final Regulations.

SECTION 337 PROVIDES that no gain or loss shall be recognized on sales by a corporation following adoption of a plan of liquidation if liquidation is complete within one year. Many knotty problems have arisen under this section, which the Regulations have attempted to clear up.

Thus, in Section 1.337-1, in order to clarify any ambiguity about sales made on the same day the plan of liquidation is adopted, the final Regulations provide that "sales may be made before the adoption of the plan of liquidation if made on the same day such plan is adopted". Although the time limit encompassed here is a narrow one, the provisions of the Regulations at least cover the possibility of having a complete sale before final corporate action need be taken.

Another point of timing which is important and is clarified under the final Regulations is the date of sale of assets, which must occur within 12 months after the date of adoption of the plan of liquidation. The proposed Regulations were indefinite and stated that such date was to be "determined from all the facts and circumstances". The Regulations as finally adopted are more specific and state:

. . "The date on which a sale occurs depends primarily upon the intent of the parties to be gathered from the terms of the contract and the surrounding circumstances. In ascertaining whether a sale or exchange occurs on or after the date on which the plan of complete liquidation is adopted, the fact that negotiations for sale may have been commenced, either by the corporation or its stockholders, or both, shall be disregarded. Moreover, an executory contract to sell is to be distinguished from a contract of sale. Ordinarily, a sale has not occurred when a contract to sell has been entered into but title and possession to the property have not been transferred and the obligation of the seller to sell or the buyer to buy is conditional."

Section 1.337-2(a)

Section 1.337-2 (a) omits the following sentence which appeared in the proposed Regulations:

"Moreover, provided the other conditions of this section are met, Section 337 applies whether the corporation or its stockholders, in fact, effected the sale."

Whether or not this implies a stricter interpretation by the Internal Revenue Service of compliance under Section 337 of the Code than was contemplated when the proposed Regulations were promulgated remains to be seen.

Section 1.337-2 (b) of the final Regulations is an apparent attempt by the Internal Revenue Service to control a situation in which recognition is sought for a loss on a sale of assets prior to the adoption to the plan of liquidation, where assets are sold at a gain after the adoption of the plan in the hope that the will not be recognized under Section 337. The final Regulations provide that where substantially all of the property covered by Section 337 is sold by the corporation before the adoption by the shareholders of the resolution authorizing the liquidation, "then the date of the adoption of the plan of complete liquidation by such corporation is the date of the adoption by the shareholders of such resolution and gain or loss will be recognized with respect to such sales."

However, where no substantial part of the property is sold before the adoption of a liquidation resolution by the shareholders, "the date of the adoption of the plan of complete liquidation by such corporation is the date of adoption by the shareholders of such resolution and no gain or loss will be recognized on sales of such property on or after such date . . ."

In all other cases the date of the adoption of the plan of liquidation is to be determined from all the facts.

The Regulations as finally adopted also tried to clear up the problem of retention of assets for unknown claimants and stockholders. A corporation will be deemed to have distributed all its assets even though it retains such amount as may be reasonably expected to be required for the payment of "unascertained or contingent liabilities and contingent expenses." Transfer in good faith to "a state official, trustee, or other person authorized by law to receive distributions for the benefit of such shareholders" will be deemed a proper retention of earnings for unknown and unlocated shareholders.

Basis, collapsible corporations, filing procedures are new in Sec. 333, 334 Regs.

by **GEORGE L. WEISBARD**

HERE IS a thumbnail sketch of the recently-released Regulations under Sections 333 and 334 of the Internal Revenue Code of 1954. Essentially, these new Regulations restate those issued under the 1939 Code, with the following significant exceptions:

The dating is, of course, different. A plan for a quickie liquidation must be adopted on or after June 22, 1954. A

corporate stockholder is ineligible for the benefits of this section if 50% or more of the company's stock was owned between January 1, 1954 and the date of adoption of the plan.

The stigma attaching to collapsible corporations is broadened by providing that such corporations [as defined in Section 341 (a)] are not eligible under Section 333.

Filing procedures are clarified. Form 964 is to be filed in duplicate with the District Director of Internal Revenue. It is important to note, with respect to the election to be filed by a shareholder, that Section 333 is not applicable to any shareholder who fails to file his election within the 30-day period after adoption of the plan. Formerly, the liquidating corporation could file this election. The new Regulations contain added qualifications as follows: "Since Section 333 applies only to gain recognized, losses realized on the liquidation will be allowed only in the year of liquidation even though Forms 964 (revised) have been filed by those shareholders who realize only losses. Such filings may be necessary to fufill 80% [under Section 332 (b)] so that those shareholders who realize gain may qualify under this section."

The problem of basis is embraced in the new Regulations, to clarify the provisions of Code Section 334 (c). Thus, the new Regulation in Section 1.334-2 represents amplification of the predecessor Section 39.113 (a) (18) promulgated under the 1939 Code. The following additional problems are covered. Where a stockholder, upon liquidation, assumes unsecured liabilities of the liquidated corporation, does this increase his base? The answer is yes. How to allocate basis to various assets received on liquidation? The answer is as follows. "Net fair market value" is fair market value less specific mortgage or pledge to which the property is subject. To the portion of basis determined for each property against which there is a lien there should be added the amount of such lien. It is immaterial whether an encumbrance is assumed or the property is taken subject to it. A number of worthwhile examples are set forth in Section 1.334-2 of the Regulations to illustrate these rules.

Current uses for preferred stock in tax planning despite prohibitions of Sec. 306

by **LESTER M. PONDER**

The final Sub-Chapter C Regulations don't change the interpretation of nor the application of Section 306 and its now-famous "hot stock." The following comments on using preferred are addressed to the situation resulting from the Code itself, not the Regulations as is the case with the foregoing articles.

IN THE ADOPTION of any utterly novel tax statute, its restrictive features are apt to dominate the initial thinking and comments of tax practitioners. More mature reflection and analysis, however, often tend to cause a revaluation of this first reaction. Thus, Section 306, which was originally hailed as a tax ogre, has certain facets which should cause no income-tax hardship in the continued use of preferred stock in many corporate transactions. In contrast to the drastic ordinary-income treatment under Section 306 (a), the provisions of Section 306 (b) contain certain exceptions which soften this harshness. The following comments are presented in light of the provisions of the new Section 306 Regulations which contain nothing novel in the interpretation of the statute.

Sale which terminates interest

If all of the shareholder's stock is sold, including his Section 306 stock, the entire sale will be treated as a sale or exchange of non-"Section 306" stock. This exception applies only if the sale is not made to a person coming within the ownership attribution rules of Section 318. Generally, this provision prevents such sales to members of the same family group in the broad sense.

The intention of this exception is that the selling shareholder retain no equity interest in the corporation after the sale. Therefore, even though the sale is not to a prohibited person under Section 318, the ownership attribution rules of Section 318 will be applied after the sale to ascertain whether the seller still constructively owns stock in the corporation. In order to remove this latter cause for concern under Section 306 (b) (1), the Section 318 "attributees" may sell all of their stock and thus eliminate possible argument.

This exception prohibits only a *stock interest* after sale, making it possible for the seller to continue as a director or employee.

Redemption which terminates interest

Section 306 (b) (2) contains a parallel exception to (b) (1) provided that all of the shareholder's stock is redeemed and provided further that such redemption qualifies under one of the specific provisions of Section 302, the section governing income-tax treatment of many stock redemptions. The ownership attribution rules of Section 318 again come into play. The further stringency of Section 302 also becomes operative in that the seller may not acquire a stock interest in the corporation or an interest as an officer, director, or employee within the 10-year period following the redemption.

Redemption liquidation

The redemption of "Section 306" stock in a partial or complete liquidation under Part II of Subchapter C will escape the impact of the ordinary-income treatment. The new "liquidation" provisions are drawn with precision; meeting their terms is clear indication that the particular distribution was not a tax avoidance choice.

Disposition when no gain or loss recognized

Disposing of Section 306 stock in transactions in which gain or loss is not recognized under any other section of the 1954 Code will not invoke the wrath of Section 306 (a), at least "to the extent that" gain or loss is not recognized. The receipt of boot would probably cause its treatment as ordinary income. In any event, taxpayers should be on their guard for Section 306 (a) treatment when boot is received in a transaction involving the exchange of Section 306 stock. (Sen. Rep. No. 1622, 83rd Cong., 2nd Sess., p. 269-270).

This entire exception of Section 306 (b) (3) embraces several types of factual situations including (a) exchanges of Section 306 stock for stock in a reorganization or in certain divisive corporate transactions under Section 355; (b) exchanges of Section 306 stock for stock of the same corporation (Section 1036 (a), 1954 Code); and (c) gifts of Section 306 stock.

Disposition not for tax avoidance

In similar fashion to Section 302 (b) (1) (the 1954 Code counterpart to Section 115 (g) of the 1939 Code) Section 306 (b) (4) contains a "safety valve" in general terms under which sales or redemptions "not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax" are excepted. This negative intent must be established to the satisfaction of the Secretary or his delegate, which seems to impose no harsher burden than would have resulted in its absence. This subsection covers two factual patterns by its terms.

First, proof that the distribution of the Section 306 stock, *and* its subsequent disposition or redemption, was not for tax avoidance purposes will remove the "Section 306" taint. An example used by the Senate Finance Committee would be the payment of preferred stock dividends and sporadic sales of such stock by minority shareholders who do not as a group have corporate control. The sheer fact that a corporation had a great many shareholders would not necessarily invoke the application of this exception, as for example, if a preferred stock dividend were issued and quickly redeemed from its shareholders under a prearranged plan.

Second, if a shareholder has made a prior or simultaneous disposition (or redemption) of the stock in respect of which the Section 306 stock was issued, Section 306 (a) will not apply. For illustration, if a shareholder receives 100 shares of preferred stock as a dividend on the 200 shares of common stock which he owns, but he sells his 200 shares of common stock before disposing of his 100 shares of preferred stock, his disposition of the preferred stock will not come within Section 306 (a).

FUTURE OF PREFERRED STOCK

That the Congress enacted Section 306 with the intention of curtailing bail-outs of earned surplus at potential capital gains rates is obvious. That its enactment did not eliminate the future use of preferred stock dividends as a tax planning technique is an equally valid conclusion. As a working rule of thumb, the preferred stock dividend will prove sound taxwise provided some *bona fide* business purpose is being served, as distinguished from the *dominant* purpose of achieving a capital gain deal.

A few of these valid reasons for issuing future preferred stock dividends readily suggest themselves. Publicly held corporations should continue to find such dividends a helpful method of rewarding shareholders for their risk investment by placing in their hands a medium of disposition by which individual shareholders may realize cash at capital-gain rates if they choose, but which require no cash outlay by the distributor. The general exceptions to ordinary income treatment found in Section 306 (b) (4) (A) appear to protect such shareholders on their sales of such stock. A corporation on the borderline between publicly and closely held may have to litigate to resolve the final answer as to whether avoidance of income tax is the "principal" purpose of the distribution and later sale.

Again, Section 306 stock still has much vitality in the increasingly important field of estate planning. The death of a shareholder owning Section 306 removes its taint. It thereby receives a new basis and, consequently, may prove decidedly useful if redeemed to pay death taxes and expenses under Section 303. An obvious advantage of using preferred stock for this purpose is to avoid the weakening of control of closely-held corporations, since common stock could be retained insofar as financially practicable. Of less favorable significance would be the issuance of preferred stock dividends directly to an estate as a shareholder and its *redemption* (not sale) for the sole purpose of paying death taxes. The preferred stock would take an allocable portion of the basis of the common stock with respect to which it was issued. If the common stock has greatly increased in value above its basis the preferred stock would likely have a favorable basis for computing capital gain upon redemption. The ownership of Section 306 stock prior to death, therefore, should produce a more beneficial estate planning result than its acquisition and redemption by an estate.

The acquisition of preferred stock should continue to be valuable in solving family unit problems. As the passing years inevitably take their toll and change new corporations into mature ones, frequent conflicts of interest arise between the active management shareholders and those who are inactive. The increased longevity of the female of the specie leads to more widows than widowers in our modern society. Thus, the inactive shareholders traditionally yearn for dividends and more dividends, whereas the active management shareholders envision expansion, improved business techniques and numerous other corporate needs of equal, or greater importance, than current dividend income. Further, these managers are usually receiving ample income in the form of current compensation, plus perhaps deferred compensation benefits, so that dividend income is relatively unattractive to them. It is here that a recapitalization might solve this dilemma. The inactive shareholders could surrender their voting stock and receive in exchange preferred stock without such preferred stock becoming Section 306 stock. Consequently, it could later be sold or redeemed with freedom from the ordinary worries of Section 306 (a).

Contributions to charitable donees offer another safe vehicle for Section 306 stock. Since such gifts would ordinarily not weaken corporate control, they offer an unusual attraction, especially to higher surtax bracket taxpayers. Fair market value is the measure of their deduction; as the market value increases, judicious giving lends itself to substantial tax savings. Especially may this be possible when contributions of Section 306 stock in a closely-held corporation are made to a family-controlled charitable foundation.

Section 306 stock may have yet another useful facet by creating diversification in the corporate financial structure. For example, it is often vital to have *in esse* both common and preferred stock in order to accomplish a desired transaction, such as sale of an entire business interest. In that event, the previous distribution of a preferred stock dividend would have resulted in no tax realization to the recipients, yet has placed in their hands an additional class of stock which might prove valuable to the pros-

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pective purchaser and thus cause an enhancement of the over-all price. This approach must be used with caution, however, because if the sale was even partially negotiated prior to the issuance of the preferred stock, the Commissioner might contend that in substance only common stock was purchased and that the preferred stock was then distributed on that common. This view would cause the preferred stock to be Section 306 stock in the eyes of the Commissioner.

New corporate decisions this month

Stock of $650, debt of $100,000; corporation too thin. Taxpayer turned over his business having a net value of $100,000 to a corporation for $650 par value stock plus a "debt" of $100,000. No note was issued for the debt; no fixed maturity or method of repayment was established. Interest payments were variable and were paid when corporate earnings justified them. Such payments are held to be a distribution of profits and not deductible as interest. *Artistic Venetian Blind Corp.*, TCM 1956-43.

Preferred debentures are stock, not debt. Payments by taxpayer corporation on its preferred debenture "stock" which was unsecured and subordinate to the general creditors are held nondeductible. They were distributions in the nature of dividends, not interest. *Schneider Lumber Co.*, TCM 1956-25.

No dividends under 1939 Code on sale of stock of one controlled corporation to another. In 1949 taxpayer sold, for $25,000, 83 shares of stock in a corporation controlled by him to another corporation controlled by him. The court holds that taxpayer realized capital gain; the sale did not lack economic reality, and the price was fair. A sales price of five times the average earnings before taxes, and slightly less than eight times the average earnings after taxes, was found to be not "unduly large" for a mercantile business. (Section 304 of the 1954 Code treats the sale of stock in one controlled corporation to another as a redemption of the stock of the purchasing corporation. *Ed.*) *Pope*, TCM 1956-41.

Distributions held to be out of earnings and profits. Taxpayer reduced the par of its outstanding stock and claimed that the simultaneous distribution to its stockholders of shares in American Airlines and Colonial Airways was a partial liquidation. This the court denies. There was no redemption or cancellation of shares. The distribution was a dividend. In determining the accumulated earnings and profit for dividend and invested-capital purposes, unrecognized losses of taxpayer on liquidation of its subsidiaries were to be disregarded. *Avco Manufacturing Corp.*, 25 TC No.

Capital gain on corporate distribution out of FHA loan. Taxpayer was a stockholder in a corporation organized to build a housing project financed by FHA-insured mortgage loans. The amount of the mortgage loans exceeded construction costs. The excess funds were used by the corporation to redeem part of its stock. As the corporation had no earnings and profits, the court holds the distributions must be applied against the shareholders' bases in the stock, and to the extent that the distributions exceed such bases the excess is taxable as capital gain. After the deficiency notices had been sent (with the result that the burden of proof was on him), the Commissioner raised the further contention that the collapsible-corporation provisions made the distributions taxable as ordinary income. This was denied for failure of proof that 70% of the gain was attributable to the property constructed. More than 30% of the gain might have been attributable to factors other than the construction, such as increase in value after construction, full occupancy, over-appraisal by the government in issuing the FHA mortgage, etc. *Wilson*, 25 TC No. 120.

Redemption of preferred stock taxable as a dividend. Taxpayer and his brother owned all the stock of the Koepke Motor Sales Co. No cash dividend was ever paid, but in 1949 taxpayer sold $6,000 of preferred stock to the corporation in order to raise money to buy a home. The Tax Court held that this redemption was essentially equivalent to the payment of a taxable dividend, and the decision is affirmed on appeal. The Tax Court also pointed out that the taxpayer's brother had withdrawn $5,500 in 1951 to make a down payment on a home. The court surmised that this, too, would have been cast in the form of a stock redemption if the Commissioner's objections had not come up in the meantime. *Koepke*, CA-6, 2/17/56.

Corporate distribution a dividend and not repayment of loan. Taxpayer advanced $200,000 to his corporation in 1943 in return for two notes maturing the following year. The corporation also carried a personal account in its books under taxpayer's name. In 1944, when the debit balance in this personal account was in excess of $200,000, the corporation credited the account for $180,000 and at the same time debited capital. In 1947 it paid taxpayer $200,000 and received the two notes for cancellation. A divided court held that the $180,000 credit in 1944 (a closed year) was not intended as a dividend but constituted a repayment of the notes; the corporate distribution of $200,000 in 1947 was therefore not a payment on the note indebtedness but a taxable dividend to the extent of available earnings. *Wentworth*, 25 TC No. 139.

TAX FREE EXCHANGES

Sale of subsidiary stock to avoid limitation of liquidation loss ineffective. From 1928 until 1943, taxpayer-bank occupied land and a building owned by its wholly-owned subsidiary. On December 10, 1943, the subsidiary passed a resolution to sell the building to the taxpayer and then liquidate. On December 13, the bank sold 20 shares and made a charitable contribution of two shares, reducing its holding to 79.5%. On December 17, the subsidiary was liquidated. The bank claimed a capital loss on the liquidation. The court held that the sales of the stock were made to avoid the rule of Section 112 (b) (6) of the 1939 Code that no loss is allowable on the liquidation of a subsidiary 80% or more owned. The sales were without substance and must be ignored. The losses were from the liquidation of a controlled corporation and were not deductible. *Granite Trust Co.*, DC Mass, 12/30/55.

Reorganization taxable for lack of "continuity of interest." Avco Corp. agreed to acquire the assets of Lycoming for use in the business carried on by its subsidiary, which already rented part of the property involved. Avco exchanged its voting stock for the Lycoming property and then transferred the property to its subsidiary. The court finds this subsequent transfer part of the over-all

plan, and since the transferors did not retain the requisite continuity of interest in the assets transferred, it holds that the exchange does not qualify as a tax-free reorganization. *Avco Manufacturing Corp.*, 25 TC No. 111.

Loss on liquidation of subsidiary allowed; parent sold share to avoid tax-free rule. On the same day that Avco Corp. adopted a plan to liquidate Crosley, its subsidiary, it sold on the New York Stock Exchange 200 of its almost 500,000 Crosley shares. Thus at the adoption of the plan it owned more of the stock than at the time of liquidation; Section 112 (b) (6) was, it claimed, inapplicable, and the liquidation is not taax-free and the loss is allowable. The majority of the court holds that this could be done. As long as the sale was bona fide, the tax motive must be disregarded. Two dissents on the ground that the sale of shares had no business purpose and should be disregarded under the *Gregory* rule. [The 1954 Code does not contain the proviso that a liquidation is not tax-free if the parent owns more stock at some time after the plan is adopted than it owns at the time of receipt. *Ed.*] *Avco Manufacturing Corp.*, 25 TC No. 111.

Loss on sale of assets to a new corporation was disallowed because the transaction had the effect of a reorganization. Taxpayer, organized in 1945, was a distiller of whiskey and other alcoholic beverages. 76% of its stock was owned by members of three families, and the balance was publicly held. The corporation, in 1948, decided to sell its non-inventory assets and liquidate. The assets were sold at a publicized public auction, but the only bid was made on behalf of a new corporation, 87½% of whose stock was owned by the same three families. The sale resulted in a substantial loss, which was deducted by the taxpayer. The Commissioner contended that the transaction was a reorganization under Section 112 (g) (1) (D) of the 1939 Code, and the loss was disallowed by Section 112 (e). The court so holds. The owners of 76% of the stock of the old corporation also owned more than 80% of the stock in the new corporation. Neither the fact that they did not own more than 80% of the old corporation, nor that all of the property was not transferred, prevents the transaction from being considered a reorganization resulting in the disallowance of the loss. *Pebble Springs Distilling Company*, CA-7, 3/7/56.

Notes held securities in tax-free exchange not basis of property acquired thereby. Certain individuals purchased from the Army buildings which had been erected on land owned by them. Taxpayer-corporation was subsequently formed and the individuals received stock and notes in exchange for the buildings. The corporation contended that in determining basis for the buildings, the face value of the notes should be added to the stockholder's basis of the buildings. The court holds that the notes issued were securities and there was a transfer to a controlled corporation under Section 112 (B) (5) of the 1939 Code (Section 351 of the 1954 Code). The basis of the property to the corporation is therefore limited to the stockholder's cost of the buildings. *Camp Wolters Enterprises, Inc.*, CA-5, 2/29/56.

Corporation organized to take over building from bondholders' committee has committee's basis. In 1947 taxpayer-corporation sold an apartment building. It contended that it had acquired the building in 1934 from a bondholders' committee in a tax-free incorporation and was entitled to use the committee's basis. The Commissioner argued that the corporation's basis was the fair market value of the property in 1934. The bondholders' committee had operated the property from 1932 to 1934, though the original owners actually delivered a quitclaim deed only in 1934. The Commissioner took the position that Section 112 (b) (5) was not applicable because the 1934 transaction resulted in a shift of the ownership from the original owners, who did not continue their interest. The court disagrees, holds that the bondholders' committee actually owned the property from 1932 on, and the 1934 incorporation resulted in a mere change in the formal ownership. *Fifty-four Ten Ridgewood Court Holding Co.*, DC Ill.

OTHER DECISIONS

Forgiveness of commercial debt is capital contribution; cost of goods is basis of corporate asset. In 1943 and 1944 taxpayer, a partner in a building-materials company, owned 1% of the capital stock of the Brazoria Investment Corporation. The partnership sold Brazoria during those years about $52,000 in building materials which were used by the corporation in constructing houses. The partnership was on a cash basis, and did not report the proceeds of the sales which were shown by Brazoria as an account payable. [No discussion of the fact that under the Regulations the partnership should have used the accrual basis. *Ed.*] The partnership did, however, deduct the cost of the material as part of cost of goods sold. In January 1945, when Greer and his father, his partner in the building-materials company, owned more than 90% of the corporation's stock, this debt due from Brazoria was forgiven and contributed to the corporation's capital. At issue here is Brazoria's tax; Greer is sued as transferee. The Commissioner argued that the cost to Brazoria of the houses it constructed should have been reduced by the indebtedness forgiven. The court holds, however, that the change in the stock ownership and the necessity of the capital contribution to keep Brazoria solvent were material changes and the forgiveness could not be related back to the purchase of the materials. Therefore, the cost to Brazoria of the houses included the cost of the materials purchased from Greer. Furthermore, in the related case concerned with Greer's gain on liquidation of Brazoria, the court holds that Greer may increase the basis of his stock by his share of the forgiven indebtedness, despite the fact that he had gotten a tax deduction for the same item in prior years. *Greer*, CA-5, 2/23/56.

Payments to stockholders for negotiating lease are reasonable compensation. Taxpayer, a real-estate corporation, agreed to pay a total of $2,500 a month to its four stockholders who had obtained for taxpayer a valuable hotel lease and a renewal. The payments are held to be deductible as actual compensation for services rendered in the past and to be rendered throughout the term of the lease. *Multnomah Operating Co.*, TCM 1956-42.

Parent of collapsible subsidiary not necessarily collapsible. If a parent corporation sells its stock in a collapsible subsidiary and realizes ordinary income, the stockholders of the parent, upon liquidation of the parent, will not realize ordinary income with respect to the same underlying collapsible property. *Rev. Rul.* 56-50.

TAX STRATEGY, NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B., CPA

AIA conference produces useful hints on filing, rulings, extensions

J. P. GOEDERT, as moderator, and Abner E. Hughes, as panelist, with the assistance of several meeting registrants, kept a pretty bright question-and-answer ball rolling at the recent Tax Conference for Business Executives sponsored by the American Institute of Accountants. From the discussion, we quote:

Timely filing

When is a return considered filed—when it is placed in the mail or when it actually reaches the government?

The 1954 Code carries a very clear statement that all documents, with the exception of certain court documents and, specifically, tax returns and declarations, may be considered as filed when they are placed in the mail. Please note the specific exception which has to do with returns and declarations. It is not sufficient to place them in the mail to consider them filed. They must reach the district director's office on or before the due date. There has been a misconception among a great many people, brought on by frequent local circumstances where a district director would advise close to filing date that he would accept returns as being on time even if they were postmarked up until midnight of the due date. That is by option only; it is not part of the law and cannot be relied on. Returns are not filed until they are in the hands of the district director.

If the return is not filed until it is in the hands of the government, how can a taxpayer actually give proof of timely filing?

Perhaps the surest way would be to deliver the return personally and perhaps to have the district director's receiving stamp affixed to a copy of the return or an appropriately descriptive transmittal letter. Obviously this is not feasible in the majority of instances. The next best thing is registered mail with a return receipt requested.

As a general rule the government has three years after the filing of a tax return for the assessment of any additional tax. However, if income is omitted in an amount exceeding 25% of that stated in the return, the government's time period extends to six years. In figuring income for this six-year rule in measuring your omission, do you use sales, or gross profit on sale? What is the basis of the 25% figure?

Here again, an area of uncertainty has been cleared up in the new law. The 25% omission tests is based on gross income, not gross profits. That would be gross receipts, gross sales, rental income, and so on. A word of caution: Frequently we hear the term misused. People think in terms of a 25% omission of the taxpayer's income. That is not correctly stating the rule. The rule applies where there is an omission of an amount equal to 25% of the amount reported. For example, if $80,000 gross income is reported in a return, and it is determined that $20,000 has been omitted from gross income, the 25% rule has been violated even though the figure I used is actually only 20% of the taxpayer's income.

Suppose the company feels that a significant item is not properly includable as income but it appears that the government may take an opposite viewpoint. How could that company protect itself from the possibility of giving the government an additional three years in which to make an assessment and lengthening the statute from three years to six years because of the 25% rule?

It is sufficient to affix a statement or a schedule to the return stating the facts surrounding the omitted income. In prior years this was an area of controversy and the Commissioner successfully contended that the income had to be actually included in the gross income on the return even though you might turn around and deduct it under deductions. It was not adequate merely to attach a statement. Now it is clearly adequate to attach an explanatory statement to the return.

Procedure on extensions

Suppose a taxpayer consents to an extension of time for the government to levy additional tax. Does this also extend the time within which the taxpayer can claim a refund?

Yes, it automatically extends the time to six months beyond the expiration date of the extended assessment period. There is an exception to this rule, however, where the return was filed under extension.

You said that an extension of time for assessing an income-tax deficiency extended also the time for filing a claim for refund. This is not necessarily true, is it, if the return was filed late with an extension?

That is correct—a very bad flaw in the law exists here. If, for example, a calendar-year 1955 return were filed under proper extension on, say, June 15, 1956, the Treasury Department could assess a deficiency against such a return as late as June 15, 1959, or on that date could enter into an agreement with the taxpayer extending the period of assessment. However, such assessment extension period gives the taxpayer six months after its expiration within which to file a claim for refund *only if the extension agreement is executed within three years from the time the return was required to be filed, without taking into consideration any extension of time for filing.* So now we have a situation where the Treasury Department can make an assessment but the taxpayer is barred from filing a refund claim. Of course, in the event a deficiency were proposed, the taxpayer could bring into play, as an offset, any items which would have been the grounds for his claim, and in the event a deficiency were paid, claim for refund could be filed within two years from its payment, the amount recoverable being limited to the amount paid during the two years preceding the filing of the claim.

I understand the procedure to be that a revenue agent is not authorized to ask for a second extension without the expressed approval of his group supervisor. Suppose a deficiency notice

is received as to a minor tax deficiency which the taxpayer readily admits to owing. Can the taxpayer use the deficiency notice to go into the Tax Court in order to contest the Internal Revenue Service disallowance of a much larger claim for refund?

That depends upon the phrase "admits to owing." If he actually admits it in writing, there is no longer any deficiency and he can not get to the Tax Court. Assuming, as I think we should, that there is going to be a deficiency, he can very definitely get into the Tax Court not only on that issue but on all issues. As a matter of fact, he must, in allowing this to go to the Tax Court, bring up all issues. That is where the final determination is going to be had, and he could not attempt later on to process a claim for refund and hope to get the same year litigated in the district court, for example.

Well, I think the question deals with the fact that there is a deficiency notice and the only item in the deficiency notice is something that the taxpayer is ready to acknowledge, in his petition, that the government is right on. But, the taxpayer then says, "I have a lot of items that the government is not right on. They are all reflected in my refund claim." Now, the question is, under those circumstances, is the taxpayer still properly before the Tax Court?

Definitely yes—on all issues.

A claim for refund is filed on the last day before the running of the statute of limitations. The government makes examination after that date. Are they barred from making additional assessment, or does the filing of a claim for refund keep open the three-year period?

In some cases the procedure you outline may be considered normal prudence. Where the taxpayer can stand it, filing claims for refund may be delayed. If and when a return is examined, the refund issues can be raised with the agent. If the return is not examined, a claim for refund can be filed at the very last moment. After the claim has gone through its preliminary processing, it may be too late for the Commissioner to assert an additional deficiency.

The filing of the claim for refund does not extend the statute. The only thing that is permitted then is for the Treasury Department to bring up any and all issues they want to the extent of overcoming the claim. They cannot go beyond it and collect a net deficiency.

What has been your experience as to the value of the group supervisor's conference procedure?

My personal experience has been that in our area the group supervisor's conference procedure has not worked too well. I do not believe the reason is lack of conscientiousness, or integrity, or effort on the part of the agents or the group supervisor. I believe they have made a determined effort to make the procedure work. Common sense indicates, however, that unless you have a rare case of an agent who is blind to the facts, or does not have all the facts, or distorts the facts given to him, we must assume that the agent has given the group supervisor a fair portrayal of those facts. After the group supervisor has studied the facts and arrived at a decision, I do not think there is much chance of his changing his mind. Consequently, we have not experienced too much use for the group-supervisor method.

Should you request a ruling?

Are there any dangers, disadvantages, or drawbacks to requesting a ruling?

There are definite dangers as well as benefits. If the transaction under review is not too complex and the return is not too large, it is entirely possible that the transaction will be subjected to only casual review by the examining agent and may never form the basis of any controversy. Therefore, when we go to Washington to request a ruling, we are deliberately jeopardizing the transaction in subjecting it to a spotlight treatment. In a consummated transaction, if the department rules against you, you are "in the soup." You cannot back out. A copy of the ruling goes to your own collection district and you are in an unhappy condition. Therefore, prospective transactions are much more suitable for ruling requests.

If a taxpayer feels he should request a ruling despite all possible adverse effects, what are the mechanics of going about that?

I might say, as a preface, that it is my feeling that we out in the hinterlands do not avail ourselves as much as we should of the ruling request procedures. I do not mean that we should dash to Washington with everything that happens to us about which we are uncertain or unhappy. I do think that where a major transaction is involved, and where tax results can be very severe if handled wrong, or could even prevent a whole transaction, then we should avail ourselves fore frequently of this procedure for the obtaining of rulings.

To start a ruling request, I cannot overemphasize the desirability of setting up an informal conference with the particular unit in Washington which would handle the request, and spell out what you plan on doing, how you reason, and get the reactions of the very people who are going to handle it. It sounds a little time-consuming to go through all that before the request is ever filed, (and it may never be filed as a result), but it pays dividends to have a man-to-man meeting with the person who is going to consider the thing. Very possibly you can eliminate much uncertainty as to what you should put in your application request. From the very outset you can comply with what the examiner feels should be the minimum statement of the facts surrounding the problem.

There are of course, rules and regulations concerning what should be put in. These include a complete statement of the facts, a statement of the part of the law on which you base your conclusions, and a clear statement as to the business reason, since rulings will not be given on a mere tax device. The written ruling request is filed and again you are given the opportunity to confer, and again, the personal discussion is highly desirable. ☆

IRS unwillingness to issue rulings stymies many deals, but there's little hope for change

THERE ARE MANY SITUATIONS in which the Internal Revenue Service will refuse to rule on a proposed transaction. Indeed it is only in narrowly prescribed categories of cases that the Service will rule, and then only if deemed consistent with a wise administration of the Internal Revenue laws. Even when the Service does issue a ruling it will exclude from its scope certain questions as to which it prefers to have the normal audit procedures develop the necessary

facts to make a determination. For example it will not give an advance ruling on a valuation question.

Basically this sort of limitation is sound, but sometimes as applied to particular situations it can be very unfair. It is no secret that many a transaction fails of consummation because the tax consequences are unfavorable, but there are many transactions which are not consummated even though the tax results may be favorable, simply because the parties will not risk proceeding without a ruling.

A particularly poignant illustration of this is in the field of collapsible corporations. If a corporation is so classified the gain on liquidation or sale of stock is taxed as ordinary income. The Service will refuse to rule, however, because it says the answer depends upon whether property which has appreciated in value is property held primarily for sale to customers. This rule is especially hard on real estate corporations because this results in a discrimination against real estate as compared with other forms of investment. If a man acquires real estate as an individual he can normally sell it without waiting three years and any profit will be taxed as capital gain just as in the case of an investment in securities. However it is normal in the real estate field to set up a separate corporation for each new development and if it is handled in the normal way legitimate real estate transactions will be stymied.

It is to be hoped that the Service will find some way of issuing rulings in this area that will satisfy prospective sellers without adversely prejudicing the interests of the government. ☆

New procedural decisions this month

STATUTE OF LIMITATIONS

Interest on overassessment runs to assessment of deficiencies credited. Interest on an overassessment of tax, offset against deficiencies, must run to the date of the assessment of those deficiencies. *Spreckels Sugar Co.*, Ct. Cls., 1/3/56.

Must produce records for barred year. The district court properly issued a subpoena requiring taxpayer to produce records for a closed year. The agent's affidavit gave sufficient indication that because of fraud, assessment might not be barred. *Globe Construction Co.*, CA-5, 1/31/56.

Uphold agreement by beneficiary of "spendthrift" trust to apply income to tax deficiencies. The government served notice of tax lien on the trustees of several trusts of which Aley, a delinquent taxpayer, was beneficiary. Taxpayer agreed to pay the taxes, some $70,000, out of income of the trusts and formally designated the Collector as agent to receive his income above $5,000 a year. Because the trusts contained spendthrift clauses, the trustees refused to do so. The court holds that the beneficiary's agreement should be enforced. The court notes that it does not decide whether the beneficiary's interest is "property" subject to a lien or whether the spendthrift clauses would be a valid defense. The question will be adjudicated if proceedings are brought against the trustees because of these payments. *Aley*, DC Ill.

Can't say Tax Court should have believed in Iraq inheritance, but fraud not proved. By applying the net-worth method, with an opening cash balance of zero, the Commissioner found substantial omissions of income by the taxpayer, who from 1941 to 1948 had made cash purchases of real property, government bonds, and other assets. His explanation of the cash was that in 1936 he returned to Iraq, where he was born, and dug up a crock buried in the basement of his deceased mother's home. He testified that he found coins and jewelry worth about $29,000 in American funds. The court confirms the Tax Court's view that the taxpayer had not overcome the presumption of correctness of the Commissioner's findings as to the deficiency. The court also held, that, as bizzare and unusual as the taxpayer's story was, the Commissioner had not met his burden of proof on the fraud question. Therefore, fraud penalties were not applicable, and the ordinary statute of 3-year limitations applied. *Kashat*, CA-6, 1/18/56.

Timely claim too vague; subsequent amendment too late. Taxpayer's first claim for refund was timely but contained only generalities. An amendment to it, filed after the claim period cannot be considered as there was no valid claim to be amended. *Butler Herbert Mfg. Co.*, DC N.Y. 1/17/56.

Three-year statute bars assessment. Taxpayer, a farmer, extended the period of limitations for 1945 by signing Form 872 more than three years but less than five years after filing the return. The court holds that there was no deficiency for 1945, since the statute had run as to that year. The Commissioner failed to meet his burden of proof that gross income from the farm, as distinguished from gross receipts, was more than 25% of reported gross income. *Romine*, 25 TC No. 98.

25% of 1942 joint-return deficiency becomes part of wife's 1943 tax liability. Husband and wife filed a joint return for 1942 (which was outlawed) and separate returns for 1943. Even though the court found that the husband's return for 1943 was not fraudulent and the statute barred an assessment against him, it held that under the forgiveness provisions of the 1943 Act, 25% of the difference between the tax reported and the correct tax for 1942 was includible as part of the 1943 deficiency of the wife, who did file a fraudulent return for that year. *Stein Estate*, 25 TC No. 109.

Informal refund claim, later perfected, sufficient. Taxpayers, partners in a retail shoe store in Petersburg, Va., were informed by a revenue agent examining their returns for 1940 through 1943 that they had inadequate records and that because of the imminent running of the limitations period on assessments, he would compute deficiencies by comparisons of income with that earned by a nearby store. The assessment was made on February 10, 1947, and on August 25, 1947, the taxpayer's lawyer wrote the Collector of Internal Revenue stating that the assessments were arbitrary. The tax deficiencies were paid in installments from November 3, 1947, through July 15, 1949. Formal refund claims were filed on June 4, 1951, and the government here contends that the claims were barred by the statute of limitations insofar as they related to payments made prior to June 4, 1949. The court holds that the August 27, 1947 letter was a valid informal claim, subsequently formalized, and the statute of limitations

was not applicable. It is irrelevant that the actual payment of the deficiency was made after the date of the letter. Judgment could not be given on the 1943 claim, however, because suit was filed more than two years after the taxpayers were notified of the disallowance of their claim for that year. *Hrcka*, DC *Va.*, 2/28/56.

Reporting ordinary income as capital gain isn't omitting gross income. Taxpayer was a cotton dealer in York, Alabama. In 1946 and 1947, in four transactions, he sold to a single purchaser about 2,000 bales of cotton which he had accumulated over a period of four years. On his tax returns, he reported the profit on the sales as long-term capital gain. More than three years but less than five years later, the Commissioner assessed deficiencies, contending that the profit was ordinary income. He further argued that the five-year statute of limitations was applicable, because the items in question were reported as long-term gain, therefore omitting one-half of the profit from income, which omissions exceeded 25% of the gross income reported. The court holds that the deficiencies are barred by the statute of limitations. An analysis of the Form 1040 shows that the taxpayer reported his alleged capital gain in exactly the way the form required. At no place on the return was there a line which included 100% of long-term capital gains in a figure of gross income. If the Commissioner's argument is correct, the only way the taxpayer could avoid the five-year statute would have been to abandon his claim that the income was a long-term gain. This the statute does not require him to do. [Under Section 6501 (e) of the 1954 Code, the disclosure made on the return would be sufficient to prevent the application of the new six-year statute. *Ed.*] *Hightower*, CA-5, 2/29/56.

Refund accrues when Commissioner signs list, not when Joint Committee fails to act. Taxpayer brought suit for interest on a tax refund. Since the Code provides no special limit on time for filing, the general six-year rule applies. The period runs from the time the claim accrued, i.e., the time the refund was allowed. The Code provides that the date of allowance of a refund is the date of the Commissioner's signing the assessment list. This rule is not affected by the fact that a refund of the size made to taxpayer could not be paid until thirty days after disclosure to the Joint Committee. *Engineers Public Service*, Ct. Cls., 1/31/56.

Tax is assessed when Commissioner signs list. Taxpayers filed their 1947 return on March 15, 1948, but did not pay the tax. The Commissioner signed the assessment list on May 21, 1948, and brought suit for the tax on April 27, 1954. The statute provides that court action must commence within six years of the assessment of the tax. The taxpayers argued that the filing of the return on March 15th amounted to a self-assessment which commenced the running of the statute. The court holds that the assessment did not occur until the Commissioner signed the assessment list. *Amori*, DC Calif., 12/14/55.

"Out-of-U.S." suspension of limitations not applicable to interest. In 1946, taxpayer received a 1942 refund plus interest. On April 5, 1950, the Commissioner reduced another refund due the taxpayer by this interest which the Commissioner contended was paid erroneously. Taxpayer argued that the two-year statute of limitations on suits by the United States to recover erroneous refund of taxes or interest had expired on the date of the offset. In view of the fact that the taxpayer had been out of the country from 1941 until her death in 1949, the Commissioner urged that a special wartime suspension of the running of the statute of limitations was applicable. The wartime statute postponed the limitations period for the bringing of suits by the United States "in respect of any liability in respect of any tax." The court holds for the taxpayer, finding that the statute did not apply to a refund of interest erroneously paid. Furthermore, even if it did, the statute started to run again on December 31, 1947, the date the special statute ceased to operate, more than two years prior to the April 5, 1950, offset date. *Crocker First National Bank*, DC Calif., 12/28/55.

Claim received on Monday timely though Saturday last day (old law). Taxpayer had an admittedly meritorious claim for refund of 1950 taxes, and the only question was whether the claim had been timely filed. It was mailed from Houston, Texas on March 13, 1953 and arrived at the Post Office in Austin, Texas early on Saturday, March 15th. In the normal course of mail handling, it would have been delivered that day. The Director's office was closed, however, and he did not actually get it until Monday, March 16, 1953. Nevertheless, the court holds the claim was timely filed, following *Peters* (220 F. 2d 544) though there the 15th was a Sunday and the court followed the rule that when the last day for doing an act falls on Sunday, it may be timely done on Monday. [Under the 1954 Code the postmark date on claim is the filing date. *Ed.*] *Francis*, DC Tex., 11/4/55.

Limitation period expired on Sunday; 872 signed on Monday invalid. The last day of the period of limitations for assessments fell on December 15th, a Sunday. Taxpayer on December 14th sent the Commission a consent extending the period. The consent was not received or signed by the Commissioner until Monday, December 16th. The court holds the agreement was not executed until signed by the Commissioner. It was not timely. [1954 Code changed this. *Ed.*] *Glenshaw Glass Co., Inc.*, 25 TC No. 135.

JURISDICTION

Tax Court has jurisdiction to determine other issues in an appeal from denial of Section 722 relief. Taxpayer filed a claim for refund for excess-profits-tax relief under Section 722 of the 1939 Code. The claim was denied by the Commissioner, and the taxpayer took the case to the Tax Court. The Commissioner attempted to assert, in the Tax Court proceeding, deficiencies resulting from other excess-profits-tax issues, but the Tax Court held it had no jurisdiction to review such standard issues in a 722 proceeding. The court reverses, holding that the statute, particularly Section 732 (b), makes it completely clear that the Tax Court has such jurisdiction. *Blue Diamond Coal Co.*, CA-6, 3/5/56.

Can bring suit for refund after paying small part of tax assessed. The commissioner assessed deficiencies for 1942 and 1943 of approximately $94,000 and $43,000 respectively. Taxpayer made payments of $2,500 on each of these deficiencies, and filed claims for refund. When the claims were denied, he brought a district court action. That court dismissed the action because only part of the deficiencies were paid. This court reverses and remands, finding that

the judicial code gives the district courts jurisdiction in a civil action for the recovery of *any* internal revenue tax alleged to have been erroneously assessed or collected. Furthermore, the Commissioner is not harmed by such a suit, because he can proceed to collect the balance of the deficiency despite the fact that the court proceedings are being carried on. One dissent on the ground that the creation of the Tax Court in 1924, so that taxpayer can contest a tax before payment, shows that it has long been understood that full payment is prerequisite to suit in the district court. It is possible to interpret the words of the old statute (1887) in accord with this clear understanding of Congress, and that should be done. *Myers Estate (Bushmaier, Exec.),* CA-8, 2/21/56.

Tax Court jurisdiction limited to taxable year. Taxpayer admitted the deficiency but contended that the income had been reported in earlier years. The court held it had no jurisdiction to determine whether an overpayment had occurred in earlier years. Even if the alleged overpayment had occurred, it did not excuse the failure to file an estimate and return for the taxable year under review. *Glowinski,* 25 TC No. 107.

ESTOPPEL

No estoppel in prior decision that premiums are deductible alimony; decision on wife is legal. In 1942 and 1943, the Tax Court held that life-insurance premiums paid by the taxpayer under his divorce agreement were deductible as alimony. For the same years, however, this appeals court held in a case brought by the wife that the payments were not taxable income. The current case involved the years 1948 and 1949. Taxpayer-husband contends that the doctrine of collateral estoppel prevents the court from making a finding different from the one made on the exact same facts in prior years. This court holds that the Tax Court was correct in finding no estoppel. Though the facts were the same, the subsequent decision on the wife's case was a change in the legal climate. *Mandel,* CA-7, 1/13/56.

Refund barred by waiver. In an extremely brief statement of facts and opinion, the court holds that taxpayer's claim for refund is barred by the waiver of assessment signed by the taxpayer in a settlement of the tax. The facts do not identify the form of waiver used. *Alexander Estate,* DC Ill., 6/24/55. *(Just now reported.)*

FILING, ETC.

Estimated tax penalty upheld; no "reasonable cause" shown. Taxpayer, a construction superintendent, received over $32,000 in 1950 as his share of the profits on construction contracts. He failed to file a declaration of estimated tax for that year. He contended that he did not know until the end of the year whether he had earned any income. Penalties for failure to file were sustained; with his long experience in the construction business, he should reasonably have known that he would realize substantial income. *Cooper,* 25 TC No. 101.

Wife's refund not available to divorced husband. An overpayment to a wife's income taxes could not be credited against deficiencies due from her divorced husband. The husband claimed he held a power of attorney from his wife to accept the refund, but the court found the power was properly revoked prior to the allowance of her claim. *Huber,* CA-6, 11/7/55.

Wife may file for incompetent husband prior to adjudication. A wife can execute a valid income-tax return on behalf of her husband while he is confined to a mental institution and before he is adjudicated legally incompetent. *Rev. Rul.* 56-22.

Hardship to taxpayer is not circumstance warranting injunction. Taxpayer, owner of a ranch and winery in California, sold his grapes to a New York corporation. The Commissioner assessed substantial income-tax deficiencies and fraud penalties. Taxpayer's explanation was that he issued duplicate weight receipts on certain loads to the manager of the corporation, and also deposited certain checks for the manager and turned over cash to him. Apparently this aided the manager in tax evasion, though taxpayer claimed he knew nothing about it at the time. The attorney who represented the taxpayer in connection with the alleged deficiencies was the manager's son, and on the insistence of this attorney taxpayer signed a Form 870 TS agreeing to deficiencies of about $24,000 and a fraud penalty of about $12,000. The Commissioner imposed a lien on the taxpayer's property; in this action, the taxpayer seeks to enjoin the collection of the taxes because the deficiencies were a fraud on him and his lawyer represented an adverse interest. The court holds that despite its sympathetic feeling for the taxpayer, the hardship imposed upon him is not so unusual as to warrant granting the injunctive relief over the specific statutory prohibition. Taxpayer could sue to recover any erroneous taxes paid, and he could be recompensated in money damages. Furthermore, Section 272(a) of the 1939 Code, which permitted an injunction when a 90-day letter had not been issued, is not applicable. Taxpayer waived the restrictions on collection and assessment, and the Commissioner is entitled to act on that waiver without issuing the usual 90-day letter. *Monge,* CA-9, 1/17/56.

Joint return allowed after interlocutory divorce decree. Taxpayers were granted an interlocutory divorce decree in 1950 by a California court. No final decree of divorce was ever entered. They sought to file a joint return for 1952, and the court held that this was permissible. "The parties are married; they are not separated under a decree of divorce or of separate maintenance." *Ellik,* DC Calif., 12/9/55.

Substitute Forms W-2 for 1956 acceptable. Substitutes for Form W-2, withholding tax statement for 1956 will be accepted by the Service in lieu of the official form if the substitutes meet stated standards. *Rev. Proc.* 55-15.

Application to use Lifo inventory not timely filed. In the Revenue Act of 1942, permission was granted to use the Lifo inventory method for tax purposes, even though interim stockholders' reports during the year were not prepared on that basis. This change was made retroactive to 1939. In amending the Regulations pursuant to the new law, the Commissioner set the date of March 10, 1943 for filing applications with respect to prior years. The taxpayer, a department store, decided to make the election for its year ending January 31, 1942. Its application and accompanying claim for refund were not, however, filed until March 31, 1943, which the

Commissioner contended was too late. The taxpayer argued that the forms for the election were not available until late in February 1943, and the March 10th date was unreasonable. The court held for the Commissioner. The Regulations setting forth the time and manner for the filing of the application to adopt LIFO were issued pursuant to statutory authorization. Other retailers were able to meet the deadline, and this taxpayer had a reasonable time to do so or to seek an extension. *Kaufmann & Baer Co.*, Ct. Cls., 1/31/56.

Separate returns may be substituted for consolidated return before due date. An affiliated group of corporations having properly filed a consolidated return may, on or before the due date of the return, file their returns on a separate basis. Similarly, a considated return may properly be filed on or before the due date notwithstanding the earlier filing of separate returns. *Rev. Rul.* 56-67.

Repeal of Sections 452 and 462 does not authorize consolidated group to file separately. An affiliated group of corporations which filed a consolidated return for 1954 on or before 9/15/55 may not elect to file separate returns for 1955 by reason of the retroactive repeal of Sections 452 and 462 of the 1954 Code. *Rev. Rul.* 56-68.

Inspection of returns. The IRS has set forth procedures relating to the inspection of individual income-tax returns by duly authorized officials or employees of the Department of Health, Education, and Welfare. *Rev. Proc.* 56-6.

Dissolved corporation can file Tax Court petition. Taxpayers were dissolved in 1947, but in 1948, Section 722 claims were filed for 1945 and 1946. The Commissioner rejected these claims in 1953 and 1954, and the Tax Court petitions were filed within the prescribed 90-day period. The Commissioner argued that the Tax Court petitions were invalid because the taxpayer no longer existed in 1954. The court disagrees. The taxpayer's existence continued for three years after dissolution under the Rhode Island law. The claims for refund were filed during this period, and the Tax Court petitions were simply part of the same proceedings which began when the corporations were admittedly alive. Said the court: "The need today for governmental revenue is indeed great, but not so great as to justify the stingy statutory interpretation the Commissioner here espouses. The country is not that hard up." *American Standard Watch Co., Inc.*, CA-2, 2/7/56.

Where a tax deficiency is abated by an excess-profits-credit carryback, interest on the deficiency may be assessed without the usual 90-day letter. On the taxpayer's excess-profits-tax returns for the years 1943 and 1944, it claimed unused excess-profits-credit adjustments from 1941 and 1942 respectively. On examination, the Commissioner took the position that these adjustments were improper, but that the deficiencies were wiped out as a result of an unused excess-profits-credit carryback from 1945. Just before the statute of limitations, as extended by waivers, expired for 1943 and 1944, the Commissioner assessed interest on the abated deficiencies from the due date of the respective returns through December 31, 1945. He did not send the taxpayer a 90-day letter with respect to either the deficiencies or the interest, and the taxpayer seeks to enjoin the collection of the interest. The taxpayer contended that Section 292 (a) of the 1939 Code required that interest be assessed at the same time as the deficiency itself; Section 272 (a) (1) of the 1939 Code required that a 90-day letter be sent before a deficiency could be assessed, and, in the absence of such a letter, a suit to enjoin the collection of the tax could be maintained; therefore, since the interest had to go with the deficiency, and the deficiency was not legally assessed and was now outlawed, the Commissioner should be enjoined from collecting the interest. The court holds that the Commissioner did not have to assess the deficiency which had been abated, and did not have to send a 90-day letter with respect to the interest. This interpretation of the statute, says the court, accomplishes substantial justice because, by paying the interest, the taxpayer may sue for a refund and have his day in court, while, because the statute had run, a finding for the taxpayer would foreclose the government from attempting to collect the interest. *Standard Oil Company* (New Jersey), DC NY, 2/27/56.

No inconsistent position in not allowing deduction for repairs deducted from basis on sale. Taxpayer was a member of a joint venture which owned and operated a steamship. In computing his income for 1941, he treated repairs of about $41,000 as a capital item. In a Tax Court proceeding for 1941, in which the Commissioner unsuccessfully attempted to tax the steamship's income to a corporation, the court held that half of the repairs was deductible as an ordinary expense. The finding was a "determination" as defined in Section 3801. The ship was sunk in 1942, and the taxpayer realized a gain as a result of receiving the insurance. The Commissioner computed the basis by including only one-half of the repairs. This action, however, was not a determination under Section 3801. The statute of limitations for a regular refund claim for 1941 had expired, and taxpayer had to rely solely on Section 3801, opening closed years, if the Commissioner adopts an inconsistent position. The Tax Court's finding in 1941 was a determination, but the Commissioner in 1942 was consistent with it. Taxpayer did not establish his right to an adjustment under Section 3801. The reason the 1941 Tax Court determination did not of itself result in a refund to taxpayer was that that action determined merely that the corporation was not taxable. Taxpayer's individual tax was not at issue. *Sherover*, DC NY, 2/2/56.

Consents operative though unsigned and unsealed. [*Acquiescence.*] Taxpayer attached to its return a Form 982, consent to have the basis of its property reduced by income from the cancellation of indebtedness, nontaxable if so applied to basis. It also attached a statement that it did not admit that it had received income. The Tax Court holds that it did realize income but that it applied against the basis; the consents, though not properly executed, were sufficient to inform the Commissioner of taxpayer's intention. *Ambassador Hotel*, 23 TC 163, *acq.* IRB 1956-11.

Overpayment on a joint return is joint and several. The amount thereof may be credited against the separate tax liability of either the husband or the wife for a prior year. *Rev. Rul.* 56-92.

Housework is not a business! Housewives are not required to file information returns (Forms 1096 and 1099) with respect to payments to domestics. *Rev. Rul.* 56-46.

EVIDENCE

Commissioner's determination upheld.

Where taxpayer entered an appearance but offered no evidence to refute the Commissioner's determination of income, the resulting deficiencies were allowed. *Sterner*, TCM 1956-33.

Prior years' records can be subpoenaed for a current examination. In connection with an examination of the taxpayer's return for 1952, his 1950 and 1951 records were subpoenaed. He objected, contending that the statute of limitations had expired on 1950 and 1951 and, in addition, his tax liabilities for those years had been fully settled. The court holds for the Commissioner, pointing out that the prior years' records were to be used only to the extent that they cast light on issues in the 1952 examination. *Norda Essential Oil & Chemical Co.*, CA-2, 3/7/56.

Employees need not answer if conspiracy to evade tax might be charged. Lindberg, a bartender, and Bodin, a clean-up man, both employed in a bar, refused to answer certain questions asked in an investigation of the bar owner's liability for gambling tax. The court holds that they could refuse to answer questions about payoffs they made or saw on the ground that they might be charged with conspiring with the employer to evade tax. *Lindberg*, DC Minn., 1/16/56.

Agent can summon taxpayer's attorney and attach accountant's worksheets in attorney's possession. The court upholds an agent's right to issue a summons to the attorney representing a taxpayer under investigation. The courts have long upheld this procedure though it is not authorized as such in the statute. This court agrees with the district court's finding that certain worksheets prepared by taxpayer's accountant, though in the attorney's possession, were the property of the accountant. Hence these records are not protected by the attorney-client privilege. *Sale*, CA-8, 1/13/56.

TRANSFEREE LIABILITY

Beneficiary must pay decedent's tax liens to extent of CSV when attached. Taxpayer's husband died in 1949 owing federal income taxes for which assessment and demands for payment had been made. Because of this action there were tax liens against his seven insurance policies. The husband had the power to change the beneficiary, to borrow upon the policies, and to collect their surrender value. At his death the policies were paid to taxpayer, his wife. The estate was otherwise insolvent, and the Commissioner contended that he could collect the assessed deficiencies out of the proceeds of the policies to the extent of their cash-surrender value when the liens attached. The court agrees, distinguishing *Rowen* (215 F.2d 641), because it was not brought out in that case that a tax lien had been created by the assessment of a deficiency and the issuance of the demand for payment prior to the insured's death. In *Rowen*, this circuit held the beneficiary did not have to pay the decedent's income tax because under New York law she received the insurance proceeds free of all claims and a liability under state law was a precondition for federal transferee liability. In this case, a lien existed against the surrender value of the husband's death. Realistically, the surrender value survived the death and became part of the proceeds of the insurance. On that assumption, the lien which was enforceable against the surrender value became a charge on the proceeds of the policies. *Behrens*, CA-2, 2/15/56.

Life-insurance beneficiary liable for decedent's income tax to full extent of proceeds. Decedent's estate was insolvent at the time of his death. The beneficiary of the life-insurance policy is held liable as transferee for the decedent's unpaid income-tax liability to the extent of the proceeds of the policies. The decedent paid all the premiums and reserved the right to change the beneficiaries, borrow on the policies, and surrender them for cash. [This Tax Court position is contrary to that of several circuit courts of appeal. *Ed.*] *Wendell*, TCM 1956-40.

No transferee liability: stock transferred but not assets. Taxpayer owned preferred stock of Mavco Sales, Inc., and the stock of Vendig, which in turn owned the Mavco common. The parent (Vendig) took over the assets and liabilities of Mavco and issued to taxpayer its own preferred stock in exchange for her preferred stock in Mavco. The subsidiary (Mavco) was then liquidated, at which time it owed federal income taxes. The Commissioner contended that the taxpayer was liable as a transferee to the extent of the value of the Vendig stock which she received. His theory was that the transaction had the effect of a sale by Mavco of its assets to the parent (Vendig) in exchange for the parent's preferred stock, and a distribution of that preferred stock to the taxpayer. The Tax Court had agreed. This court reverses; the taxpayer received no assets of the subsidiary corporation. The Commissioner's remedy lay against the parent corporation, which was the transferee of its subsidiary's assets. *Vendig*, CA-2, 11/6/55.

Widow liable as transferee to extent of insurance proceeds. Decedent carried policies on his life in which his wife was named beneficiary. He retained the right to change the beneficiary and to draw the cash surrender value of the policies up to the date of his death. The wife, who contributed nothing toward payment of the premiums, was held liable as transferee for deficiencies due on decedent's income. The Tax Court adheres to this position (affirmed in *Kieferdorf* (142 F.2d 723, *cert. den.* 323 U.S. 733), *Pearlman* (153 F.2d 560), despite other cases to the contrary (*Rowen*, 215 F.2d 641) and *Tyson*, 212 F.2d 16). *Stern*, TCM 1956-23.

Transferee has six years in which to file claim for refund. Taxpayer collected the proceeds of certain insurance policies on her husband's life. As transferee, she paid income-tax deficiencies assessed against her husband and more than 27 months later filed a claim for refund. The Commissioner contended that the claim had to be filed within two years of the payment of the tax. The court holds, that, the Code being silent on claims for taxes erroneously paid by transferees, the two-year limitations period did not apply. The general six-year statute on civil actions is applicable *Jeromer*, DC N.Y., 12/28/55.

Can correct method used in computing exclusion under claim of improper exclusion. The court finds that the Commissioner was correct in excluding taxpayer's Vinson Act excess profits from its base period net income. The claim for refund had said that the base-period income was erroneously reduced by the Vinson Act payments. This statement, the court holds, was sufficiently broad to permit change of the method of computation of the exclusion. The Commissioner figured it incorrectly on a completed-contract method, though taxpayer used percentage of completion. *Midvale Co.*, Ct. Cls., 1/31/56.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

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Supreme Court's decision in Corn Products raises basic capital-gain v. income questions

WHEN Abraham J. Briloff discussed here in March (4 JTAX 140) the tax treatment of hedging operations in the light of the recent *Corn Products Refining Company* case (350 U.S. 46), he mentioned that the Court's comment on why the transactions were not capital might well be of greater significance than the holding itself. As might be expected, the law reviews have been much interested in this change in judicial interpretation. The *Yale Law Journal* published a note by Stephen A. Weiner (Vol. 65, p. 402) which said in part:

Corn Products represents a significant change in the judicial application of Section 1221. The decision in effect rewrites Section 1221, excluding from the definition of "capital assets" *all* property held, without investment intent, in connection with the taxpayer's business. This is the first time that property has overtly been excluded from capital-asset treatment because of the policy of Section 1221; in the past, courts applying the section have at least purported to look only at its language without attempting to ascertain the congressional policy behind it. More important, *Corn Products* marks the first time that the Supreme Court has unequivocally stated that investment *is* the policy of the section. The decision could be limited to hedging transactions. [But the Seventh Circuit has just taken this position in the decision in the *Faroll Estate* case (3/15/56). Details will be reported next month. *Editor.*] However the fact that the Supreme Court chose to affirm the Second Circuit's decision on a different, nonstatutory rationale that was broader than the case required indicates that the Court did not intend the decision be so limited.

Making sense from Code, at last

The *Corn Products* approach to Section 1221 constitutes an important beginning toward making sense out of the capital-assets sections of the Code. It might be argued that the Court, believing that it could effectuate the policy of capital-assets treatment more successfully by disregarding the explicit language chosen by Congress, engaged to an unwarranted extent in judicial legislation. Nevertheless, the exceptional tax treatment given to capital assets must be supported, if at all, on an investment-business rationale. And the fact is that Congress has never been able successfully to define a "capital asset." Having initially designated all property as capital assets, Congress has proceeded to limit this definition by piecemeal enactment of exclusionary clauses. As a result, the capital-assets provisions now constitute a compartmentalized series of "pigeonholes," lacking a clear statement of standards or policy by which to determine their applicability to particular fact situations. The Court's attempt to establish a policy-oriented approach seems warranted.

Distinction is very broad

The Supreme Court's decision, however, establishes only the broadest outlines of distinction between "business" and "investment" income or loss. It does not provide workable standards by which the lower courts may determine into which category a marginal transaction should be placed. Prior judicial experience indicates this will be no easy task. Courts will have to determine, long after the event, what the taxpayer's "intent" was in acquiring and holding the property. Since the taxpayer's testimony as to his subjective intent cannot be made controlling, an "objective" standard will be required.

Any attempt to determine the taxpayer's intent from the circumstances surrounding the transaction will raise serious problems of delineation. In *Corn Products*, the taxpayer had systematically purchased and sold futures over a ten-year period in order to stabilize costs. It was not difficult to classify the gains and losses resulting from these sales as part of the "every-day operation" of taxpayer's business. But quantitative repetition as such is not a satisfactory standard; a taxpayer may make a single purchase of intangible property to accomplish a specific business goal. For example, he may have to purchase securities isued by a supplier in order to ensure a source of the product in which he deals. And if the courts interpret *Corn Products* to require a repeated pattern of dealings, the taxpayer would be unable to deduct bona fide but nonrecurring business expenses from his business income.

On the other hand, the courts should not permit the taxpayer to obtain fully-deductible business losses whenever he acquires securities in order to accomplish a business purpose. Use of this criterion would permit businessmen to write off speculative "investment" losses against "business" income. For, even though an *acquisition* is motivated by business needs, it does not necessarily follow that the securities continue to be held for business purposes after acquisition. Thus, the taxpayer who acquired securities to obtain a source of supply may not have had to *keep* the securities to obtain future supply; the supplier generally would not require the customer to retain the securities, once he has bought them. And the taxpayer may thereafter hold the securities in order to recoup some of the expense of purchasing them, through market accretion, or to maintain "good will" with the supplier. In neither instance should further losses in market value be deductible from business earnings. Plainly, this standard is also defective. Moreover, to the extent that different courts apply different standards—or apply similar standards differently—the tax burden will fall unequally upon taxpayers in like circumstances.

Nevertheless, most of the problems of classification created by *Corn Products* can be satisfactorily resolved if the Commissioner will promulgate an appropriate regulation. This regulation should provide that: any security (or similar intangible asset) acquired by a taxpayer (other than a dealer in securities) will be treated as an investment unless, with-

in thirty days after the date of acquisition, the Commissioner is notified that designated property of stated value has been acquired and is being held for specified business purposes. The Commissioner and the courts should then treat property so registered as business property, giving rise to ordinary income or loss, unless taxpayer's alleged business purpose is patently unrealistic and until taxpayer notifies the Commissioner that he wishes to hold the property for investment. Such a procedure would simplify administrative review of tax returns; it would minimize the danger of inconsistent tax treatment by eliminating the problem of retrospective judicial inquiry into taxpayer's intent; and it would require taxpayer to elect the tax treatment he prefers, and the grounds upon which he believes he is entitled to it, before he knows whether there will be gain or loss. So long as Congress chooses to distinguish between the gain or loss resulting from the sale of "capital" and "business" assets, a regulation similar to the one suggested will be necessary to enable the courts and the Commissioner efficiently to carry out the policies implicit in the Tax Code and elucidated by the Supreme Court in the *Corn Products* case.

A BASIC CHANGE OF POLICY?

A *Harvard Law Review* note (Vol. 69, p. 737) discussing the cases concerning the sale of rights to income (on which the courts have been finding capital gain) wonders whether the *Corn Products* case may indicate a changed policy in this area. It says in part:

> The problem of distinguishing between capital gain and ordinary income is particularly acute in cases where a taxpayer, in return for a lump-sum consideration, transfers for a limited time a right to receive income which in the absence of transfer would be taxable to him when realized at ordinary-income rates. Courts have found it hard to establish rational criteria in deciding whether transfers of life estates, leaseholds, oil or gas payments, or other rights to future income should be taxed at ordinary-income or capital-gain rates. Since most of such transfers can be characterized both as sales of property and as payments received in lieu of income, they could, on a literal construction of the Code, be treated either as capital gain or ordinary income. In view of the significant tax advantage accorded long-term capital gains, the resolution of this ambiguity is crucial both to the taxpayer and the government.

The Corn Products approach

The task of the courts would be less difficult if there were a discernible legislative intent to make capital gain an exception to ordinary income, or ordinary income an exception to capital gain, in cases where rights to income over time are transferred for a lump-sum consideration. If such intent could be inferred, courts could resolve doubtful cases in favor of the dominant category, leaving to Congress the responsibility for drawing finer distinctions. Writing for a unanimous Court in the recent case of *Corn Products Refining Co. v. Commissioner* (350 U.S. 46), Mr. Justice Clark maintained that "since [the capital gain provisions are] . . . an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." However, no statutory language or legislative history supporting such an approach is cited; and although the opinion goes on to state that the Court "has always construed narrowly the term 'capital assets,'" the Court appears to have taken such a position only once previously—in *Hort v. Commissioner* [313 U.S. 28 (1941)]. In that case the Court held that even if the item transferred could be characterized as "property," the payment was a substitute for rent and therefore taxable at ordinary-income rates. During the fifteen years between *Hort* and *Corn Products*, however, the Tax Court and lower federal courts decided many borderline cases in favor of capital gain. Although frequently sought, certiorari was consistently denied by the Supreme Court. Whether *Corn Products* presages the establishment of an ordinary-income approach probably depends on whether the Supreme Court is willing to grant certiorari in subsequent cases. In *Corn Products*, the Court held taxable as ordinary income gain from the sale of futures contracts by a grain processor who had purchased the contracts as a hedge against grain-market swings. While the broad language in the opinion indicates that the Supreme Court did not intend *Corn Products* to be limited to cases construing "stock in trade" and other items specifically excluded from capital assets by Section 1221, it is not unlikely that lower courts will so interpret it in the absence of further direction from the Supreme Court.

Purpose of the capital-gain sections

Perhaps the most serious obstacle to drawing a clear distinction between ordinary income and capital gain in cases involving transfers for a lump-sum consideration of the right to receive income over a period of time is the uncertainty surrounding the purposes of the capital-gain sections. Committee reports and floor debates at the time when early capital-gain provisions were enacted indicate that one purpose was to mitigate the burden to the taxpayer of paying in a single year at the progressive rates applicable to that year a tax on gain from property which had increased in value over a number of years. Thus the capital-gain provisions were originally designed to impose a tax roughly equivalent to that which would have been imposed had the gain attributable to each year been taxed that year.

A definition of "property" for the purposes of Section 1221 might also be developed from either or both of two other objectives indicated in the legislative history of the capital-gain sections. These objectives are to induce taxpayers not to hold appreciated assets off the market and to encourage taxpayers to risk funds in capital investment. The reason advanced in the legislative history for limiting the lower tax rates to transfers of "property" is that high tax rates are more likely to deter the transfer of appreciated property than they are to deter services and property from being used to produce income. Thus a property owner has the choice of selling the property and realizing a gain, or of holding it for the purpose either of realizing his gain at a future date or of avoiding realization by passing the property on a stepped-up basis to his heirs or devisees.

Judicial construction of "property"

The perplexities of construing "property" for purposes of Section 1221 are reflected in the divergent results reached where transfers for a lump sum of rights to receive income over time take different forms. To add further to the confusion, the words "sale or exchange" in Section 1222 have also proved ambiguous; and courts have frequently not made it clear on which ground decisions rest.

1. Rights to future income from per-

sonal services. Consistent with the purposes expressed in the legislative history of the capital-gain sections, courts have uniformly held that where a taxpayer surrenders the right to future income under a contract for personal services, the consideration which he receives in return is taxable as ordinary income. Similarly, Section 1241 of the 1954 Code, and committee reports explaining it, indicate that payments for surrender of the right to earn income under an exclusive distributorship contract are to be taxed at ordinary-income rates unless the distributorship is one of goods in which the taxpayer had a "substantial capital investment." Further, payments received for a covenant not to compete, except where the covenant is held to be an integral part of the transfer of a going concern's goodwill, are held to be ordinary income on the ground that the purchaser of the covenant has paid the taxpayer for the surrender of his right to earn income from a particular form of service.

2. Possessory interests in real property. In *Hort v. Commissioner* [313 U.S. 28 (1941)] a lessor, in return for a lump-sum payment by the lessee, agreed to release the lessee from the lease agreement. The Supreme Court held the payment taxable as ordinary income on the ground that it was a substitute for rent. Dictum in the *Hort* opinion indicates that if the transaction had not involved a cancellation but rather a sale of a leasehold by the lessor to the lessee, the lump-sum proceeds would also have been taxable as ordinary income. Thus the proceeds from any transfer of a leasehold by a lessor or a sublessor who retains a reversion would seem to be so taxable. In contrast, under Section 1241 of the 1954 Code, which codifies the majority view in the pre-existing case law, gain from a lump-sum payment received by a lessee from his lessor for a concellation of the lease is taxed at capital-gain rates. Similarly, it has been held that a lessee who sells his leasehold to a third party is taxable at capital-gain rates. Thus, the present distinction between ordinary income and capital gain in cases involving the transfer for a term of years of a possessory interest is based on whether or not the transferor, after disposing of the term of years, still retains a reversion. Such a distinction seems more difficult to support than one based on a requirement that the possessory interest be transferred for a minimum time in order to qualify for capital-gain treatment.

Another dichotomy in the present case law which is difficult to rationalize is that proceeds from the sale of a legal life estate by the owner of a fee are taxable as capital gain, while proceeds from the fee owner's sale of a leasehold are taxable as ordinary income. Where the life expectancy of the person whose life is the measure of the life interest is the same as the term of a leasehold, there would seem to be no reason to treat the transactions differently. It is common today to use actuarial life estimates as the basis of business decisions and for tax purposes. And the historical characterization of life estates as freeholds and terms of years as leaseholds in real property law seems irrelevant for tax purposes.

3. Oil payments. In *John D. Hawn* [23 TC 516 (1954)] and *Caldwell v. Campbell* [218 F. 2d 567 (5th Cir. 1955)] the proceeds received on the sale of a carved-out oil payment were held taxable by the Tax Court and the Fifth Circuit as capital gain even though distributions of gross proceeds to the holder of an oil payment are taxed at ordinary rates. In both *Caldwell* and *Hawn* the Commissioner argued that a distinction should be drawn between a taxpayer who transfers an oil payment carved out of his interest in the oil or gas property and a taxpayer who transfers either all of his interest, or a part thereof if the part he transfers is to continue for the same period as the part he retains. According to the Commissioner the former should be taxed at ordinary and the latter at capital-gain rates—apparently on analogy to leasehold cases where the results turn on whether or not the transferor retains a reversion. Under this view, where both *A* and *B* transfer $10,000 oil payments from the same oil and gas property, if *A* has disposed of his entire interest but *B* has only carved out the first $10,000 from his larger oil payment, *A* will be taxed at capital-gain and *B* at ordinary-income rates. Such a distinction has little economic justification; and the courts would appear correct in rejecting it although their position is somewhat surprising in view of that taken on possessory interests.

To support its position, the court in *Caldwell* reasoned that since an oil payment represents oil in the ground, it is realty and thus property for purposes of Section 1221. In addition, both the *Hawn* and *Caldwell* opinions cited cases holding oil payments to be "property" under Section 613, which allows percentage depletion to be charged against the gross income from the property; and the *Hawn* opinion cited a case holding that a donation of an oil payment to a church was a conveyance of "property" which the taxpayer could deduct under Section 170 as a gift to charity without including the amount in gross income. The courts' argument based upon the traditional characterization of oil in the ground as realty would seem no more dispositive than an argument that the lump sum received by the taxpayer is but a substitute for the ordinary income that he would have received had he retained his interest.

Responsibility for the uncertainties and inconsistencies in distinguishing between capital gain and ordinary income where rights to receive income for a given period are transferred for a lump sum is largely attributable to a statutory framework vague both in language and purpose. A reappraisal of the objectives of federal taxation and the means available for achieving them seems necessary. It is not clear that there is economic or other justification for treating many of the transactions presently accorded capital-gain rates more favorably than many of those presently taxed at ordinary rates. In the absence of such justification, the prime consideration of the tax law should be uniformity between taxpayers.

Bagley-and-Sewall-type assets

A case note in the same issue of the *Harvard Law Review* adds further interesting comment. We quote the applicable part:

> A similiar problem is encountered with assets purchased for some non-routine - but - presumably - business purpose. Stocks and bonds purchased by companies not dealing primarily in securities are generally viewed as capital assets within the definition of Section 117 (a) (I). However, where a taxpayer has acquired stock carrying with its rights to purchase property which he desires for his inventory, courts sometimes allow a loss on the stock as a business expense by treating the stock as "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . . ," and thus within an explicit exception to the coverage of Section 117 (a) (I) (1939 Code). E.G., *Western Wine and Liquor*

Co., 18 TC 1090 (1952), *appeal dismissed by consent*, 205 F.2d 420 (8th Cir. 1953). A similar approach was suggested in the opinion of the Tax Court in the *Bagley and Sewall* case, 221 F.2d 944 (2d Cir. 1955). There the taxpayer contracted to manufacture and sell machinery to a company acting in behalf of the Government of Finland. The contract required the taxpayer to place United States government bonds in escrow as security for its performance. The taxpayer purchased the bonds with borrowed funds. Immediately upon completion of the contract the bonds were sold by the taxpayer for approximately $15,000 less than their purchase price. The corporation claimed this amount as an ordinary and necessary business expense. The Tax Court held the deduction claimed by the taxpayer proper, and was affirmed on appeal.

The acquisition of securities was essential, not to purchase property for resale to customers in the ordinary course of business, but rather to obtain a contract. Other cases have allowed losses on sales of stock as ordinary business expenses, relying on the fact that the purchase of the stock was motivated by business considerations other than investment. E.g., *Pressed Steel Car Co.*, 20 TC 198 (1953). The present court, in adopting the latter approach, stressed the importance of viewing a business transaction as a whole for tax purposes instead of subjecting its closely-related parts to separate treatment. This transactional analysis has been used in other areas of tax law. See, e.g., *Kimbell-Diamond Milling Co.*, 14 TC 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951); *Commissioner v. Ashland Oil & Refining Co.*, 99 F.2d 588 (6th Cir. 1938), *cert. denied*, 306 U.S. 661 (1939). The majority pointed out that the premium on a surety bond would have been deductible as an expense of the contract and thought that the loss resulting from the use of the bonds for an identical purpose should also be deductible. They stated that part of the cost of a contract should not be singled out for tax treatment as capital loss because it was attributable to property which when viewed in another context would fall within the definition of Section 117 (a) (I). However, this transcontinental approach does not provide a standard by which the scope of the unitary business transaction can be defined. In the absence of such a standard, Section 117 (a) (I) might be rendered inapplicable by a continual reference to some "larger" business transaction.

In *Bagley and Sewall* the court found that the facts showed no investment was intended by the taxpayer. In *Exposition Souvenir Corp. v. Commissioner*, 163 F.2d 283 (2d Cir. 1947), a corporation, in order to obtain a World's Fair concession contract, was required to purchase the Fair's debenture bonds, which it sold six months after the end of the contract at a sizable loss. The Second Circuit held that the bonds were capital assets under Section 117 (a) (I) and that the loss was a capital loss. In *Bagley and Sewall* the court distinguished the *Exposition Souvenir* case on the ground that the bonds there were investments. It pointed out that in the earlier case the taxpayer had intended to retain the bonds until maturity and had treated them on its books as investmnts. Nevertheless, the case should probably be taken as casting considerable doubt on the authority of *Exposition Souvenir*.

The court's emphasis on the existence of an investment purpose as a criterion of the applicability of Section 117 (a) (I) appears unwarranted by the language of that section. Section 117 (a) (I) contains several provisions excepting certain property from treatment as capital assets. Although most of these exceptions concern property used in the taxpayer's trade or business, they do not support a blanket removal of property of a non-investment character from the application of Section 117 (a) (I). Judge Frank, dissenting, stated that these bonds were capital assets as defined by Section 117 (a) (I) and did not fall within any of the exceptions to that section, the application of which is not otherwise restricted. He termed the majority's finding of an expense based on a transactional approach "an improper judicial amendment of the statute."

Judge Frank suggested that the reasoning of the majority would require that gain realized from a sale of bonds in a situation similar to that of the present case would be taxable as ordinary income. Where the taxpayer retains bonds for a considerable time after the completion of the transaction, the bonds might be viewed as having had an investment character from the outset, and any gain or loss resulting from their sale might be treated as capital gain or loss. An alternate solution, consistent with the present opinion, would be to treat the difference between the market value of the bonds at contract completion and their purchase price as producing ordinary income or expense and any further increase or decrease in value by the time of disposition as producing a capital gain or loss. ☆

[*Editor's note*: In adapting the discussion on pages 289 and 290 for our readership of practical tax men, we have omitted certain discussion of legislative, social, and economic questions. To students of the question we commend the complete text of the Harvard note.

The authors point out that the original purpose of capital gains taxation—the avoiding of bunching at progressive rates—is no longer the dominant purpose of the special rules on capital gains. Averaging devices, used in other parts of the Code, could be used here if they were.

The authors conclude that a desirable rule would be defining property for capital gain tax as assets, not arising from personal service, on which if tax were levied at ordinary progressive rates, the tax would be significantly greater if the asset is sold than if it were retained. A rule fixing the minimum time period for which the transferred right to income must run if the taxpayer is to be taxed at capital gain rates would be both equitable and definite.]

New decisions

Ordinary income results on some principal distributions of trust liquidating title and mortgage company. The assets of an insolvent mortgage and title company were transferred to a trust which is taxable as a trust and not as a receiver. The trustee sold part of the assets and made distributions of the proceeds to the holders of beneficial-interest certificates. The amount of income or capital gain realized by the trust and required to be distributed to the beneficiaries constitutes distributable income deductible by the trust and taxable to the beneficiaries as ordinary income or capital gain, as the case may be. Any gain or loss realized by a certicate holder with respect to a distribution of trust principal as measured with his basis in the trust certificates would constitute ordinary income, because the distribution of principal is not a transaction which can be considered a sale or exchange. *Rev. Rul.* 56-78.

"Job lot" and "round lot" future contracts of same commodity are separate assets. On August 11, 1949 taxpayer purchased on the Chicago Board of Trade 50,000 bushels of May soybeans in job lot quantities, and on the same day sold short 50,000 bushels in round lot quantities. He closed out the short position in round lots during the months of November 1949 through February 1950, but held his long position in job lots over 6 months closing it out by sale in April 1950. Taxpayer reported a long-

term capital gain on his job lot transactions. A divided court upheld the taxpayer. Noting that the transactions occurred prior to the effective date of Sec. 117 (l) of the 1939 Code relating to short sales of substantially identical property, the court indicated that contracts in round lots and job lots of the same commodity were clearly identifiable as separate and distinct capital assets. *Maloney*, 25 TC No. 141.

Ordinary loss does not reduce alternative capital-gains tax. Taxpayer had a net long-term capital gain of about $1,470,000, and a net ordinary loss of approximately $64,000. He argued that the alternative capital-gains tax should apply only to the excess of the capital gain over the ordinary loss; the court disagrees. The statutory formula calls for 25% of the long-term gain, plus the regular tax on ordinary income. It is clear and unambiguous and must, therefore, be applied. The Tax Court is affirmed. *Weil*, CA-6, 2/7/56.

CAPITAL GAINS & LOSSES ON REAL ESTATE

Corporation formed to sell lands realizes ordinary income. The bondholders of a railroad organized taxpayer corporation to "liquidate" their large land holdings. Since the corporation, as an entity separate from its stockholders, was formed for and regularly engaged in the business of selling properties, all gains were taxable to it as ordinary income. The court also determined the unrecovered 3/1/13 basis of timber on which it allowed current depletion. A loss on a sale of land held on 3/1/13 was disallowed on the grounds that no evidence of cost had been introduced. *Ala. Mineral Land Co.*, TCM 1956-26.

Ordinary loss on abandonment of a real-estate subdivision. Taxpayer, a lawyer, had engaged in a number of real-estate transactions over a period of years. In 1925 he purchased a subdivision with two others. Sometime prior to 1948 he agreed to forego any profit on sale until his partners had been repaid their investments out of the sale proceeds. In 1948 when the lots were sold at a price which made certain he could get back none of his original investment, he abandoned his interest by quitclaim deed. Without discussing the facts indicating whether taxpayer held the lots for sale in business, the court holds the abandonment loss deductible in 1948 as an ordinary loss. *Tyrrell*, TCM 1956-38.

Capital gains on lots sold to cemetery as it resold them. The district court held that taxpayer received capital gain on his sale of portions of a tract of land to a cemetery. Under his agreement with the cemetery, title was transferred only as the cemetery itself sold them. This court affirms. There was no proof of a joint undertaking and the district court's findings are well supported by the evidence and the law. *Martin*, CA-7, 2/8/56.

Ordinary income on sale of defense housing. From 1942 through 1944, taxpayer built 347 single-family dwellings in California. Two hundred and twelve of these houses were initially rented to defense workers under leases containing options permitting the tenants to purchase the houses within 30 months. The others were rented without purchase options. From 1943 through July of 1946, all the houses were sold. The sales were made by the taxpayer's tract manager with the assistance of real-estate brokers. Because of the housing shortage, "For Sale" signs were not necessary. The corporation's tax returns indicated that its business included the selling of houses, and the corporate minutes approved and ratified all of the sales. On the facts, the court holds that all the homes were held for sale to customers in the ordinary course of the corporation's business, and the gains were ordinary income. *Pacific Homes, Inc.*, CA-9, 2/21/56.

Ordinary income on sale of wartime housing. In 1944 and 1945 taxpayer built 85 houses in Sunnyside, Washington. The houses were rented on a month-to-month basis, but the tenants had an oral agreement that they could apply their rent to the purchase price. Sixteen of the houses were sold in 1945, and the rest were sold in 1946 and 1947 after FHA sale restrictions were lifted. The court holds that the houses and furnaces and refrigerators contained therein were held for sale to customers in the ordinary course of taxpayer's trade or business, and the profits were ordinary income. In view of this holding, the basis of the houses did not have to be reduced by depreciation. None was allowable because the property was held for sale and was nondepreciable. *Homann*, CA-9, 1/27/56.

Holding period of property ended on the date a sales contract was made. Taxpayer bought three trawlers and their engines in 1940. All except one engine were delivered after September 28, 1941. The boats were requisitioned by the Maritime Commission and, after some negotiations, the taxpayer accepted the offered price on March 27, 1942. The documents to complete the transaction were executed on April 16, 1942 and payment was made on May 29th. The taxpayer reported the profit as a long-term capital gain under Section 117 (j) of the 1939 Code. According to the court, however, the holding period of the assets ended no later than March 21, 1942, because of the Massachusetts version of the Uniform Sales Act. The act provides for the passage of title on the contract date of specific goods in a deliverable condition. Furthermore, the holding period of all the engines commenced on November 1, 1941, when title passed to the purchaser by agreement of the parties. Therefore, Section 117 (j) did not apply because the property was not held for more than six months. *O'Brien*, DC Mass., 1/9/56.

Capital gain on agreement not to compete; not severable from assets held. Taxpayers owned and operated a linen supply business which they sold as a going concern. A covenant not to compete with the purchaser for 10 years was held nonseverable from the assets transferred, and the amounts received for the covenant were to be taxed as part of the proceeds of the sale of the business and not as ordinary income. *Faulkner*, TCM 1956-39.

Licensing arrangement treated as sale of patent rights. Taxpayer corporation, in consideration of receiving an exclusive license to manufacture parking meters with improvements developed by its controlling stockholder, agreed to pay him a royalty of $4 per meter sold. The agreement was held to have been made in good faith, and the payments were found reasonable on the basis of comparable arm's-length transactions. Although the agreement was called a license, the court held it was effectively a sale of the stockholder's entire interest in any improvements he developed. Accordingly the stockholder was

entitled to capital-gains treatment on the "royalties." *Magee-Hale Park-O-Meter Co.*, TCM 1956-57.

Transfer of a patent was sale despite payments as royalty on use. Taxpayer, a professor of physics at Princeton University, invented a machine to grind both brush and bristle ends of toothbrushes into round contours. He granted the ProPhyLacTic Brush Co. the exclusive right to make, use, and sell toothbrushes under his patents in return for a payment, designated a royalty to continue over the patent's life. The taxpayer claimed the payments were capital gain. The court agreed. The contract was subject to cancellation by either party under certain circumstances; the taxpayer agreed to defend any patent infringement suits; ProPhyLacTic could not transfer rights except to a successor in its business; the agreement covered the use of the patent only in making toothbrushes. The court analyzed other cases and finds that no one of these restrictions on the property right transferred is sufficient to make it a license not a sale. The court also held that the patent was not held for sale to customers in the ordinary course of the taxpayer's business. The taxpayer had several patents, and may have been considered a professional inventor in the optics and acoustics field. He was, however, an amateur with respect to the mechanical patent involved in this case. *Cooke*, DC N.J., 12/30/55.

DEPRECIATION

Refractory clay defined for percentage depletion. To determine the percentage-depletion rate for clay under the end-use test, a clay will be considered a "refractory and fire clay" only if it is used or sold for use for a recognized refractory purpose. *Rev. Rul* 56-59.

Can't amortize plant government is paying for. The government agreed to reimburse taxpayer in sixty installments for a war-facilities plant it erected. Taxpayer began amortization over a 60-month period and when the emergency was terminated elected to recompute amortization over 34 months. It continued to take the reimbursement from the government into income. The court refuses to allow the 34-month amortization. Taxpayer incurred no real cost and made no real investment: the amortization statute is not applicable to it. Offsetting income and deductions over 60 months properly reflects income. *Avco Manufacturing Corp.*, 25 TC No. 111.

Can amortize only per cent of cost provided in certificate of necessity. In 1944, taxpayer received from the War Production Board a certificate of necessity covering 50% or 35% of the cost of certain facilities. Taxpayer's return claimed accelerated-amortization deductions on the basis of the percentages allowed; but when the Commissioner subsequently asserted a deficiency for 1944 based on other grounds, taxpayer argued that amortization for 100% of the cost should have been allowed. The court disagrees. It noted that the Tax Court and other courts had held that the War Production Board had no power to limit certificates of necessity to a portion of the cost. If that was so, taxpayer should have brought a mandamus proceeding against the War Production Board. The Code allows accelerated amortization only if a certificate is issued. A 100% certificate never having been issued, 100% accelerated amortization cannot be allowed. *National Lead Co.*, CA-2, 2/14/56.

No deduction allowed for any part of cost of land upon which was a building erected by the tenant. Taxpayers bought land in New York City subject to a long-term lease, upon which was a commercial office building erected by the tenant before their purchase. They claimed a deduction for an alleged value of this building pro-rated over the remaining term of the lease, and they also sought amortization of what they claimed was the premium value of the favorable lease. The court holds that they are not entitled to any deductions because they offered no proof to sustain their claims. The purchase price of the land was about $428,000, and the tax assessment figures indicated a land value of $500,000 and a value for the building of $900,000. It appears that the cost of the building was already eliminated from the price. Furthermore, there was no showing that the useful life of the building would be longer than the term of the lease or that there were favorable rents to show a real premium over current rental value. *Bernstein*, CA-2, 3/5/56.

Depreciation allowed under Cohan rule even in absence of proof. [*Acquiescence.*] Taxpayer owned an auto which he used partly for business and partly for pleasure. Although he failed to prove cost, date of purchase, probable useful life, the make or model, or whether new or used, the court, applying the *Cohan* rule, allowed a depreciation deduction of $400 in lieu of the $530 claimed by the taxpayer. *Joyce*, 25 TC No. 3, *acq.* IRB 1956-11.

ACCOUNTING METHODS

Replacement of involuntary Lifo liquidation is earliest purchase in replacement years. Taxpayer operated a meat slaughterhouse. It used the Lifo basis for inventories, and had an involuntary liquidation in 1944 and 1945. These liquidations were replaced in 1946, 1947, and 1948, and the taxpayer claimed the statutory deduction in the earlier years for the excess of the cost of the replacements over the inventories liquidated. It contended that the replacement costs were measured by the meat prices in December of the later years because it could not be known that there would be a replacement until those months. The court disagrees. The statute provided for the pricing of the replacements in their order of acquisition on an annual basis. The earliest costs in the replacement years were, therefore, applicable. *Krey Packing Company*, DC Mo., 1/26/56.

Advertising agency reporting sale when contract signed needs consent to defer until performance. Taxpayer supplied advertising copy and related services under contracts, generally for a 12-month period. Prior to 1945, taxpayer, on the accrual basis, reported the full amount of the contract price as a sale when the contract was signed. Expenses were accrued when incurred. The court holds that taxpayer cannot, without the Commissioner's prior consent, recast its sales account to defer income to the years covered by the contracts. Taxpayer argued that it was in error in its method for prior years; it was making a correction, not a change. The court said there were many methods of accounting for income on an accrual basis, all of which are acceptable if consistently used. Taxpayer clearly changed its method of accounting and required consent. The Commissioner's action in recomputing income by the old method was not arbitrary; it is not the function of the court to determine the relative merits of

different methods. *Advertisers Exchange, Inc.*, 25 TC No. 122.

Fraud penalties accrue at time of filing the return. In determining earnings and profits at the end of a year for purposes of a dividend distribution, an accrual-basis taxpayer must deduct not only the contested deficiencies determined against it for that year but also fraud penalties applicable to a return filed in that year. The fraud penalty accrues when all the facts determining it have occurred; here when the return is filed. *Stein Estate*, 25 TC No. 109.

Prepaid insurance, erroneously deducted when paid, is not again deductible. A cash-basis taxpayer deducted insurance premiums paid in 1950, 1951 and 1952 for insurance coverage extending beyond those years. Taxpayer had consistently followed that practice. The court held the payments had to be prorated over the years of the insurance coverage. Taxpayer then countered it should be entitled to deduct in 1950, 1951 and 1952 the portion of the premiums paid in 1947, 1948 and 1949 applicable to the later years. The court disagreed. Since taxpayer fully expensed the premiums in the earlier years which were closed by the statute of limitations, it could not recover the cost of the prepaid expense a second time. To do so would permit the taxpayer a double deduction, to which he is not entitled. *Waldheim Realty and Investment Co.*, 25 TC No. 140.

Can't revalue inventory through hindsight. Taxpayer, a manufacturer of ice-cream equipment, transferred his business and assets to an existing corporation on 4/30/46. The inventory was transferred at cost and consisted of stainless steel, ordered to his own specifications. Later, when it was discovered that the steel was not suitable for the manufacturing process, the taxpayer sought to revise the inventory figure by a reduction of $12,300. The court refuses to allow the deduction contending that the steel was exactly as ordered and was worth its cost on inventory date, even though it later turned out to be unusable. *Myers*, TCM 1956-47.

In completed contract fee is income when collected by suit. [*Acquiescence*] Taxpayer, a partnership computing income on the completed-contract basis, substantially completed building a library for the U. S. in 1938. It accrued $2,500 for the balance due on the contract and $25,700 as the amount properly collectible to reimburse for extra costs due to governmental delays. In 1946 it secured a net judgment on both items against the government for $13,000. The court held the 1938 accrual of $25,700 improper; the amount of the 1946 judgment in excess of $2,500 represented damages and was includible in the partnership's 1946 income. In 1938 the items were "contingent and uncertain" and not includible in income under this method. *Irwin*, 24 TC 722, *acq.* IRB 1956-11.

DEDUCTIBILITY

Election to capitalize livestock binding. A partnership had adopted a consistent policy of capitalizing its breeding stock of white-faced lambs, as against including such stock in inventory. It could not therefore inventory 1,877 immature white-faced ewes on hand at the end of 1951 which the court finds were intended to be used as part of the breeding herd. The correct basis of the herd for depreciation purposes is determined at $25 per head. *Smith*, TCM 1956-30.

Can't deduct penalty for intentional OPA violation. [*Certiorari denied.*] A judgment was rendered against the taxpayer for intentional violation of OPA regulations. He sought to deduct the amount of the judgment as a business expense. The Tax Court held that the district court's determination that the violation was wilful was conclusive under the doctrine of collateral estoppel. The Seventh Circuit affirmed. Such amounts are not properly deductible, because to allow them would be contrary to public policy. *Lentin*, CA-7, 10/14/55, *cert. den.* 1/9/56.

Can't deduct property paid to APC as interest of enemy stockholders. [*Certiorari denied.*] Taxpayer, a Netherlands corporation, was partly owned by German shareholders. The corporation turned over to the United States Alien Property Custodian property in this country roughly equivalent to the value of the German interest in the corporation. It claimed a tax deduction for this payment, contending it to be a loss "connected with income from sources within the United States." The court denied the deduction; the property was taken under the Trading with the Enemy Act and its allowance, as in the case of a fine or a forfeiture, would be against public policy. *Algemene Kunstzijde Unie, N.V.*, CA-4, 9/19/55, *cert. den.* 2/27/56.

Can't defer uninsured loss beyond year of occurrence. Taxpayer's newly-constructed storage tank collapsed in 1950. In the following year taxpayer filed a claim with its insurance company which was denied. It sought to deduct the loss in 1951. The court holds taxpayer could not defer the loss beyond the year of collapse. It was unreasonable to conclude in 1950 that the loss was covered by insurance or that it would be made good by the builder. *Coastal Terminals, Inc.*, 25 TC No. 119.

Concrete driveway a capital expenditure. The construction of a concrete driveway was not a "repair" of an old unsatisfactory gravel one, but was a completely new installation having a greater value and a different useful life. The cost is therefore a capital expenditure and not deductible. The adjusted basis of a warehouse demolished to make room for a new building is held to be part of the cost of the new building. *Jones*, 25 TC No. 124.

Wife's expenses in helping her husband entertain are not deductible. Taxpayer was the president and only active officer of Utility. Utility charged off travel and entertaining expenses representing payments incurred by taxpayer and by his wife while accompanying him on his business trips. The court disallowed part of taxpayer's expenses for lack of proof and all of the wife's expenses. It held that any services which the wife may have rendered in assisting her husband in entertaining his customers were no more than any interested wife would render under the circumstances; and services which Utility may have received from her efforts produced entirely nebulous benefits. *Crabbe*, TCM 1956-52.

Guarantor of loss can't take deduction before making good. Taxpayer organized a woolen mill and agreed to make good losses sustained for the years 1948-1950. The evidence failed to disclose in what manner taxpayer assumed the losses except to deduct them on his tax returns. The court holds taxpayer, on the cash basis, could not deduct any losses unless actually sustained as the result of cash payment. *Haas*, TCM 1956-50.

No deduction for payment to co-stockholders to induce lease to corporation. Taxpayer and two brothers agreed to invest equally in a new corporation. The brothers held a leasehold valued at $15,000 which they contributed to the corporation upon taxpayer's payment to them individually the sum of $5,000. Such payment is held to constitute an increased capital investment in the corporation. There was no assignment of the lease to taxpayer; any benefit he received from the payment came only from his participation as a stockholder in the corporation which was to enjoy occupancy of the leased premises. *Sokol*, 25 TC No. 128.

Unamortized tooling cost deductible on making decision to change line. In 1947 taxpayer decided to cut its 1948 manufacture of old-model ranges and freezers and launch a new line. Some of the work was being done for it by an affiliate which had incurred substantial tool cost on the old line. The affiliate was amortizing the tool costs at an agreed rate on production, and taxpayer had agreed to reimburse it for unamortized cost if it stopped purchasing. In 1947 the affiliate computed the amortization it would incur on the 1948 planned producton and billed taxpayer for it. The court agrees the deduction is allowable in 1947. All the facts had occurred to fix the loss. *Avco Manufacturing Co.*, 25 TC 111.

Can't deduct selling expenses for both income and estate taxes. Expenses re sale of property are not allowed as an offset against the sales price in computing the taxable income of an estate if the expenses have been deducted for the federal estate tax. *Rev. Rul* 56-43.

Cost of microfilming back newspaper issues was a deductible expense. Taxpayer operated the *Times-Mirror* newspaper in Los Angeles, California. It kept two bound sets of back papers, although some issues prior to 1910 were missing because of a bombing of the taxpayer's plant. Because of the possibility of war damage in 1943 and 1944, the taxpayer had all its old copies microfilmed. It claimed that the cost was deductible as an ordinary and necessary expense, but the Commissioner contended that it was a capital item. The court holds that the microfilming created a subsidiary record which would be valuable only in an emergency and was currently of little worth. The cost was incurred as insurance against a disaster and was deductible as an ordinary and necessary business expense, even though the microfilmed copies had a physical existence of more than one year. *Times-Mirror Co.*, CA-9, 2/29/56.

Patronage refund must arise from pre-existing legal obligation. A nonexempt cooperative association was not permitted to exclude patronage dividends where it failed to show a pre-existing legal obligation under which its patrons were entitled to such earnings without some corporate action. *Christian Quarries, Inc.* TCM 1956-55.

Cash-basis machinist can't deduct items in inventory. Taxpayer purchased parts (castings) needed by a customer and was paid when he delivered the finished work containing the part. At the year end he held a considerable inventory of these castings; he must wait until he sells them to his customers or otherwise disposes of them before he can deduct their cost. *Jones*, 25 TC No. 124.

Buyer of property prior to lien date can deduct real-estate taxes (old law). When taxpayer acquired property in Oregon in April, 1949, real-estate taxes had been assessed but tax lien had not as yet attached. He later paid the tax and the court permits him to deduct it. The lien not having attached, he was not perfecting title. [Section 164 of the 1954 Code provides for apportionment of such taxes between buyer and seller. *Ed.*] *Asthmanefrin Co., Inc.*, 25 TC No. 129.

WHAT IS INCOME

Deduction allowed for accrued expenses applicable to prior loss years. In determining the business deduction of taxpayer's lumber and timber business, for which few records were kept, the court allowed taxpayer to accrue as of 12/31/48 expenses incurred in 1946, 1947, and 1948 and paid in 1949 and 1950. The specific year the expense was incurred was ruled unimportant, since the business was commenced in 1946 and taxpayer sustained substantial losses in 1947 and 1948 available as carrybacks to 1946. This court notes that the record was extremely confusing and that while it was not an auditing body it made a careful effort to determine income. Taxpayer's contention that he overvalued his inventory in error was overruled for lack of proper evidence. *Sloan*, TCM 1956-36.

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Gain on repayment of foreign liability due to change in exchange rate is ordinary income. Taxpayer imported shoes from an English company on credit. In 1935 it recorded a purchase liability of $12,000, the dollar equivalent of the invoice in pounds sterling ($4.86 per pound). All the shoes were sold over a two-year period, during which time taxpayer showed losses from operations. The debt was not paid until 1947, when the rate of exchange was down to $4.02 per pound. Taxpayer paid the liability with $10,000 and claimed the profit of $2,000 was not taxable but was an offset against the losses on sales. The Tax Court held that the transaction in 1947 involved a speculation in foreign exchange entirely separate from the purchase and sale of shoes in prior years. The gain was ordinary income, since the purchase of foreign exchange was not an investment but a recurring business transaction. This court affirms. *Church's English Shoes Ltd.*, CA-2, 2/7/56.

Advances for services are income, not loan. The taxpayer received money from a corporation which hoped to derive profits from the development of ideas on which the taxpayer was working. Taxpayer contended that the corporation was to be reimbursed out of the initial profits and that the amounts received by him were loans and not compensation. The Tax Court held that the financial arrangement constituted a profit-sharing scheme. Since the taxpayer had no obligation to repay in the absence of profits, the advances constituted taxable income. This court affirms. *Bouchard*, CA-6, 2/6/56.

Minister's house allowance exempt under 1939 Code. The IRS will no longer tax allowances made to a clergyman under the 1939 Code to cover the cost of a parsonage. IT 1694, which held to the contrary is revoked [The 1954 Code specifically exempts these receipts from tax. *Ed.*] *Rev. Rul.* 56-58.

Customer's deposit treated as a liability, not income. Taxpayer claimed a deduction in 1948 because of the government's failure to deliver certain surplus materials which it purchased and paid for. The deduction was denied; taxpayer failed to prove that its claim against the

U. S. became worthless in the taxable year. A deposit of $5,000 received by taxpayer from one of its customers to be applied against a purchase of some of this material was credited to a liability account instead of sales income when taxpayer determined that the merchandise could not be delivered. This treatment was held proper; the deposit was not includible in taxpayer's income. *Crabbe*, TCM 1956-52.

Punitive damages are ordinary income. Taxpayer, a motion-picture theatre operator, received treble damages in an action under the antitrust laws arising out of a conspiracy by distributors of films. The receipt of the money was held to constitute ordinary income on the authority of the Supreme Court's decisions in *Glenshaw Glass Co.* and *Goldman Theatres, Inc.*, 348 U.S. 426. *Bloom*, TCM 1956-49.

Payment on termination of employment is taxable. Taxpayer, upon terminating his employment with the Motion Picture Association of America, received the sum of $38,270. Taxpayer had requested the sum and agreed to execute a general release of all claims against the Association. The amount was charged by the Association to salary expense. The court holds no gift was intended; the payment was taxable as compensation. *Jackson*, 25 TC No. 125.

Promoter taxed on stock received as kick-back. A promoter of building corporations hired an architect for the projects and paid him with corporate stock. The stock was immediately transferred to the promoter pursuant to a prior agreement. The court holds the fair market value of the stock was taxable to the promoter as ordinary income for services rendered. Distributions by the corporation in partial redemption of this stock were taxable as dividends only to the extent of the accumulated and current earnings. *Weaver*, 25 TC No. 121.

Corporate funds used by stockholder are income to him. [*Certiorari denied.*] Large payments to a corporation from its customers were taken and used by the corporation's sole stockholder. As a result, the stockholder was convicted of criminal fraud. On appeal, he contended that the money taken from the corporation was not proven to be income to him. The court held that the amounts received by the stockholder were income to him because he had, and exercised, complete control over them. The government did not have to show that the money was received as dividends or compensation. Conviction affirmed. *Davis*, CA-6, 10/13/55, *cert. den.* 2/27/56.

Voluntary payments to employee's widow are gifts. The widow of the general manager of a department store received $20,000 in 1951 and $5,000 in 1952 from her deceased husband's employer. At the time of payment the widow was not and never had been an employee or official of her husband's company. The payments were made voluntarily, and thought they were charged to salary expense that fact is not determinative. The court holds the intent of the payor governs and these payments were gifts. *Matthews*, TCM 1956-46.

No income on $100,000 house bought for $40,000 though seller did business with buyer's in-laws. [*Acquiescence.*] Taxpayer and his wife had a residence constructed for them by a contractor recommended by the wife's father. The contractor had been employed by the father on large construction projects. He was anxious to obtain the father's goodwill and future business, and quoted a price of $40,000 which he anticipated would not leave him any profit. The actual cost of construction totalled $102,000 because of "extras" and increased labor costs, but taxpayers paid only the agreed price of $40,000. Taxpayers did not receive income by virtue of the fact that the cost of construction and the fair market value of the residence was in excess of the purchase price. The purchase of property for less than its value does not, of itself, give rise to the realization of taxable income. There was no employer-employee relationship from which the differential might be inferred as compensatory, nor were any elements of a dividend present. *Pellar*, 25 TC No. 42, *acq.*, IRB 1956-11.

Stock received by parent for services to its subsidiary not income. Taxpayer-corporation manufactured and sold machinery. It had a wholly-owned subsidiary doing business in Great Britain. Prior to 1949, the parent had agreed to furnish engineering services to the subsidiary for a fee. Thereafter the subsidiary, in need of capital, agreed with the taxpayer that the obligation under the pre-existing agreement would be discharged by the issuance of additional subsidiary's stock. During 1949, the amount due the parent under the original contract was about $120,000, which sum was paid in additional capital stock of an equivalent par value. The Commissioner contended that the taxpayer had taxable income in the form of an accruable right to $120,000 subsequently satisfied by the stock. The court holds, however, that since both the original agreement and the supplementary understanding existed throughout 1949, all that the parent was entitled to was stock of its subsidiary. The receipt of this stock was the equivalent of a stock dividend which did not enrich the parent at all. In effect, the taxpayer had contributed the value of the services to its subsidiary's capital. The subsequent receipt of cash representing part of the contract value of the services rendered in later years did not indicate a right to such a payment for 1949 of sufficient definiteness to constitute an accruable item. One dissenting opinion; the income accrued, the prior agreement to use the funds for stock in no way affected the earning of the income. This was the Tax Court's finding which, far from being clearly erroneous, was amply supported. *Joy Mfg. Co.*, CA-3, 2/29/56.

Salary received in lieu of workmen's compensation benefits nontaxable. Workmen's compensation payments received by an employee are excludable from his income. If he turns over such payments to his employer in return for his regular salary only the excess salary over his benefits would be taxable unless such excess qualifies for the sick pay exclusion under Sec. 105 (d). *Rev. Rul.* 56-83.

BASIS

IRS clarifies donee's basis for gifts of business inventory. In this ruling, originally issued in August 1955, the IRS took a new position with respect to income-tax treatment of gifts of agricultural or manufactured products or property held for sale in the ordinary course of business. The fair market value was held not includible in the donor's gross income. However, the property must be removed from the opening inventory and the current year's costs, if any, applicable to the donated property are not available as tax deductions. The basis of the gift in the hands of the

donee was held to be the same as in the hands of the donor.

In this revision the Service explains that the donor's basis is his cost, properly not deducted. However, the donee's basis in the case of his sale at a loss is limited to fair market value at the date of gift *Rev. Rul.* 55-531 (*revised*).

Can't use alternative valuation for estate under $60,000. An election to value the gross estate as of one year after the date of death or as of an intermediate date may be made only with respect to a gross estate which exceeds the statutory exemption of $60,000. [It follows that the basis of the assets of such an estate must be the value at date of death, not one year later. *Ed.*] *Rev. Rul.* 56-60.

Estate-tax value accepted as heir's basis for gain. Taxpayer sold his minority interest in a closely-held corporation in 1947 for $900 a share. He had acquired the stock from his grandfather's estate in 1937. The court accepts the estate-tax valuation of $177.70 as taxpayer's basis, subject to an upward adjustment for attorney's fees incurred to perfect his title to the shares. *McEwan,* TCM 1956-27.

Pre-1939 state contributions to employee's pension fund increases his basis. Amounts contributed prior to 1/1/39 by a state or its political subdivision to employees' tax exempt pension funds may be added to the amounts contributed by the employees, in computing the consideration paid for annuity contracts, for the purpose of arriving at the exclusion ratio. *Rev. Rul.* 56-82.

Value of stock issued is basis of assets received. The IRS has clarified its *Rev. Rul.* 54-96 to emphasize that the basis of assets acquired in a taxable exchange is the cost to the acquirer. Where stock is used to purchase assets, the basis is the fair market value of the stock given up, not the fair market value of the assets received. *Rev. Rul.* 56-100.

Basis of inherited option is its value at death. [*Acquiescence.*] Taxpayer was given by his father's will an option to purchase stock from the estate at a fixed price. Taxpayer sold the option. The Tax Court holds that the basis of the option was its value at date of death. Sale of the option below that basis resulted in no gain. In the *Mack* case (3 TC 390, *aff'd.* 326 U.S. 719), a similar option was exercised and the basis of the stock so acquired was only the cash paid. The value of the option was not included. The Tax Court here says merely that the *Mack* case is distinguished because the property, not the option, was sold, *Cadby,* 24 TC No. 97, *acq.* IRB 1956-11.

Value of land and water rights determined. In the early 1900's, the taxpayer was engaged in lumber and timber operations in northern California. On March 1, 1913, it owned certain land and water rights. The March 1, 1913 value of these properties, necessary in the computation of gain on subsequent sales, was determined by the court. *Red River Lumber Company,* Ct. Cls.,3/6/56.

WHOSE INCOME IS IT

No tax on partners who relinquish right to contested income. A minority stockholder claimed that taxpayers, the majority stockholders, were improperly operating a partnership in competition with the corporation. In a settlement agreement, the partnership relinquished its claim to income. The income was received and given up in the same year. The court holds the income was not taxable to the partners and was properly included in the income of the corporation. Attorneys' fees in effecting the settlement were deductible by the corporation as ordinary and necessary expenses. *Bishop,* 25 TC No. 110.

Income from business given to wife by her husband was taxable to her. In 1940 taxpayer, in order to minimize his liability in a damage suit against him, conveyed a blowpipe business in Jacksonville, Florida to his wife. She thereupon hired him to operate the business for a salary measured by 50% of the profits. The Commissioner contended that the transaction was a sham and all of the income continued to be taxable to the husband, but the court holds otherwise. The transfer of the property to the wife was in proper legal form, and it belonged to her thereafter. The facts showed that she exercised a greater measure of control over the business than before the transfer. Therefore, income from the operation and use of the property was taxable to her. Operational management was furnished by the taxpayer, who, under agreement with his wife, was paid a salary for his services as manager. This alone was taxable to him. *Montgomery,* CA-5, 3/7/56.

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THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

Income-splitting hazard under new gifts-of-securities-to-minors laws

MANY TAX MEN are now considering the taxability of income from securities given to minors under the new custodianship laws sponsored by the New York Stock Exchange, which New York State has just passed. This makes nine states which have now adopted the law. (For a description of the model statute, see 4 JTAX 106.) This requires a careful study of the cases on outright gifts and gifts in trust to see how the rationale would apply to the new gifts. *Revenue Ruling* 56-86, issued last month, see page 311, discussing the gift-tax status of transfers under the Colorado statute, says merely, "The income-tax consequences of such a transfer are still under consideration."

J. Carlton Fleming, attorney, of Charlotte, North Carolina, researched this question (in 34 *North Carolina Law Review* 207) with particular reference to the statute of his state. Since the statutes in the states that have adopted this type of law are virtually identical, his conclusions will be useful to tax men in other states too. This is what he had to say:

Basic provisions of the law

In 1955, eight states (Georgia, North Carolina, California, Colorado, New Jersey, Connecticut, Ohio, Wisconsin) followed the suggestion of the New York Stock Exchange and adopted a statute simplifying the procedure for making gifts of securities to minors. The "Gift of Securities to Minors Law" unquestionably provides a useful vehicle for transferring certain types of securities. In addition, it presents interesting possibilities for the minimization of federal taxes by shifting income within a family group.

In general, the new law provides that a valid transfer of registered securities may be made to a minor simply by registering them in the name of any adult member of the minor's "family," or in the name of any guardian of the minor, followed by the words "as custodian, for ——— (name of minor)." Securities in bearer form may be transferred by delivery to any adult member of the minor's family (other than the donor) or to any guardian of the minor, accompanied by a deed of gift duly acknowledged, in substantially the form set forth in the statute. A very liberal definition of the term "security" permits the application of the new provisions to most categories of intangible personal property.

A gift made in the prescribed manner is irrevocable and conveys to the minor indefeasibly vested legal title to the securities. A guardian has no rights with respect to such securities unless the guardian is also the custodian.

The custodian is required to collect the income from the securities held by him and to apply all or part of such income and all or part of the principal, as he deems advisable, for the support, maintenance, education, and benefit of the minor. To the extent that property held by the custodian and the income thereof is not so expended, it is delivered or paid over to the minor upon the minor's attaining the age of twenty-one years, and in the event that the minor dies before attaining the age of twenty-one years it is delivered or paid over to the estate of the minor.

By far the most important provisions of the new law relate to the rights, powers, and duties of the custodian. The custodian has authority to sell, exchange, convert, or otherwise dispose of any and all of the securities held by him in such manner and at such time or times, for such prices and upon such terms, as he may deem advisable. He has the power in his sole and absolute discretion to retain any and all securities delivered to him within the meaning and under the authority of the section without reference to the statutes relating to permissible investments by fiduciaries. He is required to invest the minor's property in such securities as would be acquired by prudent men of discretion and intelligence who are seeking a reasonable income and the preservation of their capital without reference to the statutes relating to permissible investments by fiduciaries. He may vote any securities held by him. In short he enjoys the rights and powers bestowed upon trustees under many liberal trust agreements.

His clerical duties are not burdensome. Accounting is required only upon petition to the superior court by the minor after attaining age twenty-one, a parent or legal representative of the minor, or a successor custodian. He cannot be required to account more than one year after delivery to the minor after he has attained age twenty-one, or to the estate of the minor.

A custodian who is not compensated for acting as such is not required to give bond for the faithful performance of his duties and is not liable for any losses to the property held by him except such as are the result of his bad faith or intentional wrongdoing or result from his investing the minor's property in a manner other than as prescribed.

The protective provisions for brokers, transfer agents, and issuers are exceedingly broad, stating, *inter alia*, that "no issuer of securities, transfer agent, registrar or bank, or other person acting on the instructions of any person purporting to be a custodian or donor shall be responsible for determining whether any person has been duly designated as a custodian . . ."

Taxation of income of custodianship

A review of cases, discussed below, suggests that a grantor who reserves to himself, as trustee or otherwise, a substantial measure of control over the corpus of the trust runs a strong risk of taxation. Yet a father who makes an outright transfer of machinery or land to his child, or a transfer of property to himself as guardian for his child, or a valid transfer of securities to a brokerage account for his child, has usually avoided income tax despite retention of

control. In the trust cases, the grantor who provides that income can be used for support of his dependents has found himself taxable on all the income of the trust, or, in more recent times, on that portion actually applied for support. However, in cases involving outright transfers, brokerage accounts, and guardianships, reviewed below, application of income for support of the minor has not been fatal.

Into which category of cases does the custodianship logically fall? Factually, the custodian is quite similar to the managing parent in the brokerage account cases. If those decisions are followed, the income of a custodianship seems clearly taxable to the minor and to no one else.

Even if the brokerage account cases have lost some of their former persuasion, it is suggested that the custodian's resemblance to a guardian, rather than to a trustee, should result in taxation to the minor. Basically, a grantor-trustee may prescribe his own ability to control the property transferred, whereas a donor-custodian cannot. A custodian's authority flows from legislative grant. Presumably, the legislature can narrow the control of the custodian by subsequent enactment. Consequently, although the custodian may today have a considerable measure of control over the securities he holds, tomorrow he may be governed by the same rules that now apply to guardians. Futher, since a donor-guardian can apply income for the support of his minor children without subjecting himself to taxation in his individual capacity, it seems that a donor-custodian, also a creature of the legislature, should be subject to a like rule.

Nevertheless, a conservative view must recognize the possibility that the courts will hold that the coexistence of the ability to apply income for support of depndents and legislatively-granted control available *in a particular year* require taxation of income to a donor-custodian in that year, at least, under the statutory definition of gross income. Although the *Clifford* and *Douglas v. Willcuts* doctrines have thus far been limited to cases involving trusts, there is no assurance that the future will not see their application to other types of transfers. It can scarcely be contended that the present Supreme Court is of a mind to restrict the meaning of "gross income." In a single day in 1955, the Court decided that both "insider profits" under the Securities Exchange Act of 1934 and recoveries of treble damages under the federal anti-trust laws were within the scope of Section 22 (a) of the 1939 Code.

Unquestionably, the current uncertainty as to income-tax consequences will result in the deferring of many transfers that would otherwise take place under the new law until the matter has been clarified by ruling or decision. Nevertheless, it seems probable that a good many parents will calculate the tax risk and will make gifts to their children of income-producing securities, perhaps hedging their position to some extent by naming a relative of the minor other than themselves as custodian. A taxpayer who calculates the risk may find, in his own case, that the figures are attractive. If the transfer is recognized for income-tax purposes, the income is shifted to the normally lower tax bracket of the minor. Moreover, the child will continue to qualify as a dependent regardless of the amout of income he receives so long as he is under age 19, or over that age but still a "student." If the income of custodianship is taxed to the donor, he merely pays the tax he would have been obligated to pay, plus interest. A sound middle ground is available to a parent who desires to make a transfer for the benefit of his child, not anticipating that the income will be made available for support and maintenance prior to majority. Under Section 677 (b), 1954 Code, if the transfer is made in trust, income will not be taxable to the grantor merely because such income may be applied for the support or maintenance of a beneficiary whom the grantor is legally obligated to support, except to the extent that such income is so applied. If, on the other hand, a parent with similar motives makes a transfer to a custodian, and is held to be taxable on the income of the custodianship by virtue of ability to apply income for support, presumably *all* of the income of the custodianship would be taxable to the donor, even though none had actually been applied to discharge of his obligation, under the doctrine of *Helvering v. Stuart*, which held that a grantor is taxable on all trust income which may be applied for the support of his minor children, although none is in fact so applied.

In at least one situation involving transfers for the support of minors, a custodianship would appear to be currently preferable to a trust, despite the unsettled state of tax law. Prior to the adoption of the 1954 Code, a favorite arrangement saw a grandparent transferring property to his son as trustee for the support and maintenance of the grandchildren. It is quite possible that the son in such a situation is now subject to taxation on that portion of the income of the trust actually applied to the support of his minor children. Such would appear to result from the application of Section 678 (c) of the 1954 Code.

Retention of control

If a father were to establish for his minor child a trust providing that the income could be used for the support of the minor child, or accumulated in the trustee's discretion, there could be no doubt that at least that portion of the income actually used for support would be taxable to the father. Moreover, should the father reserve certain "administrative powers," such as the power to direct in a non-fiduciary capacity the voting of stock of a corporation in which the holdings of the grantor and the trust are significant from the standpoint of voting control, all the income of the trust would be taxable to him under Section 675 (4), 1954 Code.

Is it possible that by making use of a custodianship under the new law, the father can avoid the income tax he would otherwise have to pay if he were the grantor of a trust designed to perform the same functions? Obviously, a conclusive answer cannot be given. No case has yet considered the status of a statutory custodian. Yet, a consideration of the cases involving outright transfers, guardians, and brokerage accounts on the one hand, and the *rationale* of the decisions in the trust cases, on the other, casts considerable light on the problem. The roles of application of income for support of minor children and of control in the donor or grantor merit particular attention.

There are a significant number of cases holding that, *where a trust is not utilized*, income from property transferred to a minor will be taxed to the minor and not to the donor, even though the donor retains a large measure of control over the property transferred. Thus in *A. N. McQuown* [P-H 1953 TCM, Section 53, 204 (1953)], a father transferred undivided interests in road-building machinery to each of his three children. Thereafter the father, as agent for the children, rented the machinery to himself and other con-

tractors, exercising control over the rental equipment and collecting the income for the benefit of the children. The Tax Court held the income to be that of the children and not of the father. "The appointment of petitioner, a donor, to manage the equipment was not fatal." Similarly, income from cattle grazing, and wheat land owned by a minor has been held to be taxable to the minor rather than his donor-father despite "managerial control" by the father while his son was away at school. *Alexander v. Commissioner,* [190 F.2d 753 (5th Cir. 1951)].

The Emil Frank doctrine

Where the minor's property is held by his guardian (even though the father has often been both donor and guardian) the courts have been unanimous in applying the dictum of the United States Supreme Court in *Freuler v. Helvering* [291 U.S. 35 (1934)] that "the whole of a minor's income received by his guardian is taxable to the minor irrespective of its accumulation in the guardian's hands, distribution to the minor or payment for his support or education."

The Tax Court has considered a number of cases involving gifts of securities to minors by means of transfers to a brokerage account managed by an adult. Perhaps the high-water mark was *Emil Frank* [27 BTA 1158 (1933)], in which the petitioner and his wife made gifts of securities to brokerage accounts managed by the petitioner for the benefit of their three daughters, all of whom were minors. Substantial amounts of the income were applied to their support, maintenance and education. Nevertheless, the Tax Court held that the income was attributable to the separate property of the minors, and was not taxable to their father. In *Edward H. Heller* [41 BTA 1020 (1940)], a father managed brokerage accounts for his minor children. The accounts contained securities transferred by the father and others, but none of the income was applied for support. Although the father had designated himself "trustee" in opening the accounts, the entire income of the accounts was held to be taxable to the minors and not to the father, as a trustee or individually. To like effect are *Reginald Fincke* [39 BTA 510 (1939)], *Herbert L. Dillon* [32 BTA 1254 (1935)], and *Prudence Miller Trust* [7 TC 1245 (1946)],*acq.* 1947-1 Cum. Bull.

Although the *Emil Frank* line of authority has been neither overruled nor limited by holdings in subsequent cases, dictum in *Daniel J. Fry* [4 TC 1045 (1945)], holding a purported transfer to minors not to be a completed gift, hinted that the Tax Court might no longer find them persuasive. "Petitioner places some reliance upon a group of cases in which it was held that a parent was not required to include in his gross income the profit resulting from operating brokerage accounts in the name of his minor child or children. *Emil Frank, ... Herbert L. Dillon, ... H. C. Priester . . . .* See, however, *Harry F. Canelo,* 41 BTA 713 (appeal, CA-9, dismissed) where the duties incumbent upon a parent under such circumstances are discussed at length. All of the cases were decided prior to the *Clifford, Griffiths, Eubank,* and *Horst* cases cited at the beginning of this opinion. Whether they have lost any of their value as precedents need not now be decided" (4 TC 1045, 1052). It should be noted that *Edward H. Heller* adverted to the *Clifford* decision, but did not consider it applicable. Five years after the appearance of the *Daniel J. Fry* dictum, the Tax Court distinguished, but did not suggest disapproval of, its decision in *Emil Frank.* [*Bendix,* 14 TC 681, (1950)].

Emil Frank doctrine ignored

The dictum was ignored when, in 1954, the Tax decided *Clay H. Brock* [22 TC 284 (1954)], an interesting example of family benevolence in which the petitioner, an adroit trader in commodities, established separate trading accounts with a broker in the names of two minor daughters, two brothers, two sisters, and two nephews. He made deposits in each account under an agreement with the account owner that profits would be used first to repay to the donor the amount of the deposit, but that thereafter gains and losses would be shared equally. The entire income of the accounts prior to repayment of the deposits was held taxable to the donor on the ground that the income was attributable to his "labor" and capital. However, it was held that after the advances had been repaid, one-half the profits retained in each account were property of the account owner and the donor was taxable only to the extent of the remaining half. Thus, although the donor had full trading control, and two of the accounts were established for his minor children, he escaped taxation on all income which, under the agreements, was payable to account owners. There was no finding on the application of income for support. The Tax Court cited no authority for holding half the income taxable to account owners rather than the donor.

As previously pointed out, the grantor of a trust used to support his minor children would be taxable under Section 677, 1954 Code, or, if he retained the proscribed administrative powers, under Section 675 (4). These sections, however, apply only to grantors of *trusts.* Since the Internal Revenue Service as well as the courts recognize clearly the distinction between a trust and a common-law custodianship, is the Commissioner left without statutory basis for holding income taxable to a donor-custodian?

But is it gross income?

Strangely enough, although most of the cases holding the grantor of a support trust taxable on its income cite Section 167 of the 1939 Code and corresponding sections of prior law which are substantially similar to Section 677 of the 1954 Code,[1] the fountainhead for the proposition, *Douglas v. Willcuts* [296 U.S. 1 (1935)], relied on the statutory definition of "gross income." Although *Douglas v. Willcuts* has been cited as holding that Section 167 of the 1939 Code requires that a grantor be taxed with the income of a trust which discharges his legal obligations, a careful reading of the opinion of the Supreme Court indicates that its decision rested solely on the application of the term "gross income." Thus, it does not suffice to say that Sections 677 and 675 (4) cannot apply to a custodianship. The father must also escape what the Supreme Court has termed the "sweeping scope" of the statutory definition of "gross income."

Those who felt that Congress had properly laid to rest the *Clifford* doctrine when it provided in Section 671 of the 1954 Code that a grantor could not be taxed "solely on the grounds of his dominion and control over the trust under Section 61 (relating to definition of gross income) or any other provision of this title" except in accordance with the specific statutory rules contained in Sections 671-678, may well witness its resurrection. Although the Commissioner can no longer make use of the statutory definition of gross income in taxing grantors of trusts, the

donor in a custodianship presumably remains fair game. Surely the Commissioner could find comfort in many of the hundreds of decisions handed down during the fourteen year tenure of the *Clifford* doctrine.

Too much has been written of the *Clifford* puzzle to justify a further summary of decisions. However, a consideration of a few of the cases is essential to any attempt to project the probable course of judicial thought relating to the taxation of a donor-custodian. It has been correctly stated that the *Clifford* case turned on four factors: (1) the length of the term of the trust, (2) the identity of the trustee, (3) the identity of the beneficiaries, and (4) control. In *Clifford* itself the fact that the grantor retained a reversion after a relatively short-term trust was found to be most persuasive. In cases involving no reversionary interest in the grantor, the Tax Court has held that control over investments alone does not bring the grantor of a trust for his children within the *Clifford* rule.[2] A donor under the gift-of-securities-to-minors law has no reversion, since the securities held by the custodian are transferred outright to the beneficiary at age twenty-one, or to his estate in the event of death during minority. In the absence of a reversion, is it possible that the element of control alone is sufficient to result in taxation of the donor?

Fourth circuit cases

Since in most instances where the North Carolina Gift of Securities to Minors Law is utilized, tax appeals would be heard by the Court of Appeals of the Fourth Circuit, the decisions of that Court are of particular interest.

In *Hash v. Commissioner* [152 F.2d 722 (4th Cir. 1945), *cert. den.* 328 U.S. 848, *rehearing den.* 328 U.S. 879 (1946)], a husband and wife each owned a half interest in a partnership which operated a furniture store and a finance company. The husband transferred one-half of his interest in trust for one of his daughters, and the wife made a similar transfer for the benefit of the other daughter. The trustees of the husband's trust were the wife and their attorney, while the husband and the attorney acted as trustees under the wife's trust. The trustees, the husband, and the wife entered into a partnership agreement. The Fourth Circuit, relying on the fact that control of the business remained in the husband and wife, held the income to be taxable to the respective grantors. There was no mention in the opinion of the length of the trust, or of the father's duty to support. However, from the opinion of the Tax Court below [*Rose Mary Hash*, 4 TC 878 (1945)], it is clear that the grantor had no reversion, and that none of the income of either trust was applied for support of the children. The dissent by District Judge Coleman, sitting in the absence of Chief Judge Parker, emphasizes that the case turns solely on the issue of control over the property held in trust: "To uphold the Tax Court in the present cases would be tantamount to saying that a parent cannot, without continuing to pay income taxes as though the property were still in fact his own, give property, by a deed of trust no matter how absolute, to a child so long as the parent himself is one of the trustees, if—even though in the exercise of honest, business judgment the trustees feel that they can thereby best preserve and increase the child's trust estate—they invest the trust corpus in a business in which the father himself is interested and has invested his own money because he considers it a sound investment."

The Fourth Circuit continued to emphasize control as a decisive factor in *Stanback v. Robertson* [1833 F.2d 889 (4th Cir. 1950)]. Fred and Thomas Stanback were partners in Stanback Company, a partnership which manufactured Stanback Headache Powders and other products and held real estate and securities. In 1937, the investment assets were transferred to a corporation. The operating business continued under a new partnership agreement. Each brother established separate trusts for his wife and minor children with a bank and the other brother as trustees. To each of these trusts, each brother transferred shares of stock in the corporation and a six per cent interest in the partnership. Under the new partnership agreement, the brothers were general partners and the trustees limited partners. By reason of the control of the *partnership* (rather than the trust) the court held the income from the *partnership* taxable to the grantors. Apparently the Commissioner had not contended that the income from the corporation was taxable to the grantors, although a similar measure of control would seem to be present. It is interesting to note that the Tax Court had considered the same trusts for two previous taxable years and had held the grantors not taxable in a decision from which the government did not take an appeal.

A recent Fourth Circuit decision resting primarily on the presence of the control factor is *Wheeling Dollar Savings & Trust Co. v. Yoke* [204 F.2d 410 (4th Cir. 1953) *cert. den.* 346 U.S. 898 (1953)]. There the grantor created five substantially identical trusts, with himself as trustee, for the benefit, respectively, of four nephews and a sister, none of whom were owed a duty of support. The grantor retained broad powers of management and control, could add income to principal or invade principal. The corpus of each trust would eventually be distributed to the beneficiary unless the beneficiary died during the grantor's lifetime, in which case the trust estate would revert to the grantor. The district court held the income of the trusts taxable to the grantor. The Fourth Circuit agreed. "The significant factors in the pending case in support of the District Court's decision are that Wolf had no need for the income from the trusts, that the beneficiaries were his closest relations, that he named himself as trustee and endowed himself in this capacity with full power of control and management, including the right to sell the property at any price he might determine, the right to reinvest the proceeds in any property he might think desirable, the right to rent the property for terms of any duration, and the right to borrow money and secure the loan by mortgage of the property; in other words, as he expressed it in the trust instrument, the right to manage, control, and distribute the trust estate for the benefit of the beneficiaries as if the property were absolutely owned by him." Although the

[1] Section 677, 1954 Code: "Income for Benefit of Grantor":

(a) General Rule—The grantor shall be treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party, or both, may be—

(1) distributed to the grantor;

(2) held or accumulated for future distribution to the grantor; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor.

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under Section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

(b) Obligation of Support—Income of a trust shall not be considered taxable to the grantor under subsection (a) merely because such income may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed.

[2] B. H. Klein, 14 TC 687 (1950); *Glenn S. Allen, Sr.*, P.H. 1944 TC Memo, Dec. ¶ 44,014.

court's decision was bolstered by the presence of a reversion in the grantor, unquestionably it considered the control factor as most convincing.

Federal gift and estate tax

A problem which has often perplexed practitioners seeking to arrange transfers for the benefit of minors is the fear that the annual exclusion provided under the federal gift-tax laws may be lost by virtue of a gift being held a transfer of a "future interest." Section 2503 (c) of the 1954 Code, which provides that certain transfers for the benefit of minors shall *not* be considered gifts of future interests, is clearly applicable to gifts under the gift-of-securities-to-minors law, thereby qualifying such gifts for the annual exclusion.

There would appear to be no occasion for the inclusion of property transferred under the gift-of-securities-to-minors law in the taxable estate of either the donor or the custodian, except in the event of a "transfer in contemplation of death" by the donor within the three-year period ending with his death. ☆

New decisions affecting individuals

No alimony deduction for payments made for childrens' support. Taxpayer agreed to pay his ex-wife $125 per week in consideration of her supporting his two minor children. Upon her remarriage, the weekly payments were to be reduced to $31.25 per child, and as each child attained the age of 21, $31.25 was to be eliminated from the payment. The court holds the amount for the support of the children is identifiable and permits taxpayer to deduct only one-half of weekly payment as alimony. *Eisinger*, TCM 1956-48.

Separation agreement held incident to divorce. [*Certiorari denied.*] A husband and wife entered into a separation agreement. The agreement did not refer to a possible divorce in any way because the wife was opposed to a divorce. Nevertheless, the husband promptly obtained a Florida decree. The Tax Court held that there was no "mutuality of intent" in the settlement agreement and it was not, therefore, incident to the divorce. The Appeals Court reversed: payments are deductible by the husband and taxable to the wife whenever a legal obligation to support, evidenced by a written agreement, survives the divorce. *Holt*, CA-2, 10/25/55, *cert. den.* 3/5/56.

Installment alimony, contingent on death or remarriage, deductible (stipulation of parties.) Divorce decree required the taxpayer-husband to pay $24,000 to his wife in $200 monthly payments. In the event of wife's death or remarriage, payments were to stop. The Tax Court held the payments to be installments of a sum which, despite these contingencies, was fixed. The payments are therefore not deductible. Furthermore, as the final installment was due 18 days before the expiration of 10 years from date of decree, these were not installments payable over more than 10 years and therefore deductible alimony. On appeal, by stipulation, the case is remanded to the Tax Court to allow the alimony. *Isfalt*, CA-7 2/29/56.

Marital support payments not "alimony"; neither are installments of fixed sum decreed to wife. Periodic payments made by a husband pursuant to a decree were not deductible as alimony where the decree did not determine the right to separation but only enforced the husband's obligation to support his wife through the marital relationship. In a later decree which granted an absolute divorce, the husband was ordered to pay his wife weekly payments upon the total sum of $60,000 which was found by the court to be the remaining and unpaid portion of the wife's share of her husband's property. Such amounts were not deductible as "periodic payments" since they constituted installment payments of a fixed principal sum. *Keleher*, 25 TC No. 132.

Cash settlement with wife not deductible as periodic alimony payment. A husband, pursuant to a decree of legal separation, agreed to pay over to his wife 1/3rd of the income that he might receive from the estate of his grandparents. The agreement further stipulated that if the wife should obtain a divorce and remarry, the payments were to cease and the wife would then get in cash a sum equal to the payments for the 3 preceding years. The wife obtained a valid divorce, remarried, and received a lump sum of $43,500 under the terms of the agreement. The court holds the cash settlement was not a periodic payment of alimony and was therefore not taxable to the wife. *Senter*, 25 TC No. 138.

Professional musician's "home" is hotel where he is playing; can't deduct travel expenses. Taxpayer was a professional musician playing solo in hotels in the Wisconsin area. His engagements varied from a week or two to several months. He had been brought up in Milwaukee, returned there when free, and used his mother-in-law's apartment there as a business address. His wife and child travelled with him. The Tax Court disallowed travel expenses and meals and lodging. He was not away from home. This court affirms on the authority of the *Flowers* case. *Fisher*, CA-7, 2/8/56.

No deduction for fireman's meals while on duty. A fireman's business "home" is at his principal or regular post of duty and includes the entire city or general locality. Meals consumed at the firehouse, even while on duty, are not deductible as traveling or business expenses. *Rev. Rul.* 56-49.

Electrician can't deduct travel to his farm residence each weekend. Taxpayer, an electrician, in arriving at his adjusted gross income deducted: (1) traveling expenses of $1,005 expended for 201 days' meals and lodging at $5 per day at 3 different places of employment in Kentucky, Tennessee, and New Orleans; and (2) car expenses at 7c a mile in going back home each weekend. Taxpayer's home was Mississippi, where he carried on a small farming operation. The meals and lodging are deductible, because incurred on temporary employment away from home. The cost of the trips to his home and return to where he was working are denied, since they constitute personal expenses incurred primarily to visit his family. *Loden*, TCM 1956-29.

No deduction for expenses to secure appointment as trustee. Legal fees and court costs incurred by taxpayer in a proceeding to be appointed a trustee of a trust created by his father's will which, if he had been successful, would have put him in a position to receive annual compensation as trustee, were held not deductible either as business or nonbusiness expenses. Taxpayer was not de-

fending or prosecuting an existing right or interest, but was attempting to obtain income by the creation of some new interest. *Statler,* 25 TC No. 134.

Hotel operator can deduct cost of own meals. [*Non-acquiescence*] Taxpayer and his wife owned and operated a hotel. They and their daughter lived at the hotel and gave their full time and attention to its operations. The court allowed them to deduct the full cost of meals served and full depreciation on equipment. The Commissioner had eliminated from expenses the estimated cost of meals and other services used by the taxpayer, his wife, and daughter. These costs are ordinary and necessary expenses. *Doak,* 24 TC 569, *non-acq.* IRB 1956-11.

Rental value of stand is income to barbershop bootblack. Income derived by an individual from the operation of a shoeshine stand in a barbershop where he also performs services as a porter is includible in computing net earnings from self-employment. The fair rental value of the shoe shine stand represents "wages" received for services rendered, and can also be taken as a deduction attributable to the shoeshine business. *Rev. Rul.* 56-66.

Unreimbursed partnership expenses may be deducted by individual partner. An agreement between partners provided that a partner should pay travel and entertainment expenses out of his personal funds. The court holds the partner can deduct these unreimbursed expenses from his individual income. *Klein,* 25 TC No. 118.

Stock bonus not deductible as compensation for past service. Crasto, upon incorporation of his glass business, caused it to issue corporate stock to certain employees. He claimed as compensation expense on the final return for the business as a proprietorship the excess of fair market value of the stock over some cash paid by the employees. The motive for the stock issuance was not clear; the three employees were treated alike but taxpayer was about to marry one, another was threatening to quit, and the third was little more than a clerk. The court holds that the so-called stock bonuses were an inducement to the employees to work for the newly-formed corporation; and that the deduction could not be taken by Crasto individually. *Crasto,* TCM 1956-37.

Domicile of traveling engineer determines rights to file as community. [*Acquiescence.*] On the facts taxpayer, an engineer, was held domiciled in Arizona, a community-property state, and hence entitled to file his returns for 1943-1947 on a community-property basis. Although he traveled extensively in the course of his work, his wife and children returned to Arizona in 1936 and there was no evidence that any other domicile was acquired thereafter and prior to 1950. A domicile once acquired is presumed to continue until it is shown to have been changed. Even though a single form was filed for taxpayer and his wife, it was intended as a separate community-property return for each combined onto one form. *Whitmore,* 25 TC No. 41, *Acq.* IRB 1955-10.

Rentals applicable to period prior to enactment of Oklahoma Community Property Statute were separate income. The taxpayer and her husband were residents of Oklahoma, which on July 26, 1945, passed a community-property law applicable only to property acquired subsequent to its enactment. The taxpayer had rented business property in Oklahoma City on a percentage lease for five years beginning October 1, 1944. On October 15, 1945, she received a rental payment for the period ended September 30, 1945, based upon the tenant's gross sales. The Commissioner contended, and the court holds, that the rent payment, to the extent that it was computed on sales made prior to the effective date of the community-property law, was the taxpayer's separate income and could not be split with her husband. *Smith,* CA-10, 2/14/56.

Compromise payment included the full amount of interest on the taxpayer's deficiencies. Prior to 1946, taxpayer owned the Longchamps chain of restaurants in New York. In September, 1946, a closing agreement settled taxpayer's liability for the years 1940 through 1944 at about $800,000, and various corporate liabilities at just over $4,900,000. In 1947 the restaurants lost their liquor licenses, and the taxpayer wanted to sell out his interest. To facilitate the sale, the Commissioner entered into another closing agreement, settling all the deficiencies of the plaintiff and his corporations for a payment of $3,000,000 in cash and $200,000 in notes. In arriving at this agreement, the fact that the corporations would probably operate at a substantial loss after losing the liquor licenses was taken into consideration. The taxpayer contended that the 1947 settlement included the payment of all of his personal taxes plus interest, for which he was entitled to a deduction, and the court so holds. The only compromise involved in the 1947 agreement was with respect to the corporations. Furthermore, where, as here, surrounding facts and circumstances indicate the part of a lump-sum compromise payment that represents interest on deficiencies, the interest is deductible. Unless otherwise specified, partial payments are attributable first to interest, so that the taxpayer's interest was included in the $3,000,000 cash payment in 1947 rather than in the subsequent payment of the $200,000 in notes. *Lustig,* Ct. Cls., 3/6/56.

Employee not in business; cannot deduct entertainment or club dues. Taxpayer was employed as district sales manager of a steel company. Deductions for customer entertainment in excess of the amount for which he received reimbursement were denied since he failed to show that he was required by his employer to make such expenditures. The *Cohan* rule was applied in determining the amount actually spent for contributions, sales and gasoline taxes, and technical publications. He could not however deduct any of his club dues as a business expense since as an employee he was not engaged in any trade or business. *Brookfield,* TCM 1956-56.

Parents denied exemption for child supported by state. Taxpayer's child was committed to a state training school as an invalid. During 1950, the state spent over $700 in full support of the child. In 1954 it secured a judgment against the taxpayer for reimbursement. The parents were held not entitled to a dependency exemption. In that year they had only an unmet obligation to support. *Donner,* 25 TC No. 117.

Double penalty on failure to file estimate (old law). Taxpayer filed no declaration of estimated tax for 1950 and 1951. The Tax Court sustains the Commissioner in assessing both the penalty for failure to file and the penalty for substantial underestimation. [Under the 1954 Code there is only one penalty—that for underpayment. *Ed.*] *Williams,* TCM 1955-325.

MANAGEMENT OF THE

Professional tax practice

AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

Good tax service to clients by lawyers demands that the Bar permit specialization

TAX PRACTICE is the area most often mentioned in the argument, usually heated, for and against official sanction of professional specialization. Bound up with this question is unauthorized practice, the lawyer-accountant controversy, and larger questions of whether professional responsibilities can be met in today's circumstances so long as professional groups forbid a vigorous and clear-cut specialization.

Harrison Tweed, a senior New York lawyer widely respected for his service to the legal profession, made some extremely interesting observations on this touchy subject in the course of his *Benjamin N. Cardozo Lecture* at the Association of the Bar of the City of New York last October. In this, the fourteenth annual Cardozo lecture, Mr. Tweed came out vigorously for greater specialization. Because of the significance of this development to tax practice, we report here those passages which bear on tax practice. These are Mr. Tweed's words, selected by the editors. Mr. Tweed is a partner in the New York firm of Milbank, Tweed, Hope & Hadly.

No one needs to be told that there have been great changes in every aspect of life in this country in the last hundred years—changes in business, commerce, finance, science, politics, and the general economy. The increases in taxation and the growth of labor unions have brought much legislation in both fields, and this in turn has brought an enormous amount of negotiation and litigation. Did the lawyers appraise the situation and avail themselves of their opportunities to serve the public? They did not. They regarded the sort of work involved as largely beneath their dignity and requiring more reading and study than it was worth.

Meanwhile, laymen had made it their business to become proficient in the provisions of the tax and labor laws and the accounting and other problems involved. They promptly developed themselves into quasi-professionals and asserted their qualifications as against those of lawyers. And because they were specialists in the particular fields they were able in a great many of the matters brought to them to do the work just as well as lawyers and at a lower cost. The Bar did not compete intelligently or protest loudly until the revenue value of the business had been demonstrated. Then very largely it invoked the doctrine of the monopoly of lawyers to practice law and, asserting a broad definition, appealed to the courts for protection. It is irrelevant whether this was or was not the right approach. The point here is that the Bar as a whole was not alert to the relative benefits and detriments which the situation presented and lost business through a failure to qualify itself to do the work involved. The Bar has been slow to recognize the existence and the imperativeness of the demand for change, and that it is only where the compulsion of the demand has been strongest that it has been adequately met.

Quality of service is vital

Those lawyers who practice in partnerships meet reasonably well, although far from perfectly, the standards in quality of advice to clients which should be maintained if the Bar is to discharge its public obligations. The same thing is not true of those who practice alone, as do something over two-thirds of the lawyers in this country all the way up and down the line from the rural areas to the biggest metropolis. They might be divided into two groups, although there exist no figures and no information as to how many there are in each group. One would consist of those who have made no effort to concentrate and to become proficient in any particular field of the law. The other would include those who have concentrated in one or two or perhaps three fields of law. Many lawyers have learned that most clients require proficiency which the lawyer cannot give if he has spread his education and reading and experience over the entire legal territory. In order first to have clients and then to be able conscientiously to handle their legal problems, a proficiency is necessary which can be acquired only by a certain amount of specialization.

The ad hoc partnership

How is the client to be assured in every case of the judgment of the generalist and the proficiency of the expert? It is not possible to make every generalist an expert in all fields, or even in one, to guarantee that every specialist shall have the wisdom, broad viewpoint, and wide experience which can only come with extraordinary ability, unusual education, and a practice reaching into many fields.

The answer is, of course, that somehow the judgment of the generalist and the expertness of the specialist must be combined for the benefit of the client. In an article in the *American Bar Association Journal* for December, 1955, Professor Charles W. Joiner has christened such a combination an "*ad hoc* partnership." He means by that a joint venture in the service of the client by two lawyers who cooperate to give the combination of judgment and technical knowledge to which the client is entitled. There is nothing mysterious about such a combination although it raises some problems.

It might be suggested that the development of *ad hoc* partnerships would increase the cost of legal service. I do not think so. The record clearly discloses that the work done by formal partnerships is done more economically for the client. The lawyer who is unfamiliar with the problem presented to him must do far more work and will therefore feel entitled to charge more than the specialist who can answer the question almost offhand. But if the client does pay more it is because he gets something that is more valuable. Nothing is more obvious than that the public will not pay more than it believes the service it receives is worth. The Bar

must take its chances in the marketplace. The law is a profession but its clients are also customers. And it will not succeed by giving cheap service, which is not good service. The financial welfare of the Bar depends upon the volume of business which the public gives it. The mathematics are simple. The greater the use that the public makes of the profession, the larger the aggregate earnings of the profession. The distribution of those earnings among the members of the profession will depend upon a number of considerations, the most important of which is the value of what each has to offer. Lawyers always have competed among themselves and it is proper that they should in order that the efficiency of the profession be maintained. By and large the share of the aggregate which each lawyer receives will depend upon what he contributes to taking care of the volume of service which the public seeks from the profession.

Super-specialization, fragmentation

Clearly there is an urge among lawyers, and perhaps particularly among younger lawyers, to make themselves and their brethren at the Bar better lawyers through special training and concentration in practice. The satisfaction of this urge can be of great value to the Bar. But it can also result in fragmentation of the profession and in over-specialization in education and practice.

If no affirmative action is taken by the organized Bar or by influential lawyers, the present trend will continue. One point of view counsels avoidance of affirmative action and, notwithstanding the known risks of over-specialization on the one hand and loss of business to the profession because of a lack of expertness on the other hand, leave everything to fate. That would be to repeat the errors of the past, when lawyers neglected their opportunities in the early development of administrative or quasi-administrative law. Certainly it would be unfortunate for a learned and formally organized profession to perpetuate the nineteenth-century theory of *laissez faire* and to ignore a serious internal problem.

Another alternative would be to try to discourage the spread or intensification of specialization. This would seem to attempt to reverse the course of human events. It does not appeal to me personally and it is supported disinterestedly by very few lawyers. Furthermore, it is hard to visualize a procedure to accomplish such a purpose without disastrous results. If the public were deprived of the expertness it requires of lawyers, it would be very quick to turn somewhere else, and if legislative help were necessary to overcome the obstacle of the Bar's monopoly in the practice of the law, the public could undoubtedly get it. Is it not the better alternative that the Bar, on the one hand, wholeheartedly encourage proficiency and specialization and, at the same time, do its utmost to guard against over-specialization and fragmentation?

Bar association action

What has the organization done? The short answer is "almost nothing." But I should mention, however, the abortive attempt of two or three years ago. Robert G. Storey, writing as president of the American Bar Association in its *Journal* for February, 1953, said:

"The legal profession has not kept pace with the rapidly changing events and demands of our time. Admission to the Bar is a license to a lawyer to perform almost any legal operation that an unsuspecting client may invite. The neophyte lawyer is automatically certified as competent to advise a corporation on its tax liabilities, to draw oil unitization agreements, and to negotiate consent decrees in antitrust suits."

It resulted that two special committees were appointed by two successive presidents of the American Bar Association. I was a member of both of them. Each reported in favor of a thorough study of the problem and action designed to encourage specialization and safeguard against excesses. A subcommittee of the Board of Governors reported along the same line to the House of Delegates in March, 1954. The House adopted resolutions to the effect:

"1. That the American Bar Association approves in principle the necessity to regulate voluntary specialization in the various fields of the practice of the law for the protection of the public and the bar, and

"2. That the American Bar Association approves the principle that in order to entitle a lawyer to recognition as a specialist in a particular field he should meet certain standards of experience and education, and

"3. That the implementation, organization, and financing of a plan of regulation to carry out such principles is delegated to the Board of Governors, subject to final approval by the House of Delegates."

The Board of Governors arranged for a hearing in October, 1954, at which, as is usual, there were more objectors than supporters of the proposal. The Board then reported to the House of Delegates in August, 1955, that it had decided not to present to the House of Delegates the plan which it had prepared because "it had reached the conclusion that the plan is not feasible." This report of the Board was approved by the House without discussion on this point.

The arguments for and against the plan were not designed, on the one hand, to support the precise details of the plan or, on the other hand, to oppose those details. For the most part, they were arguments in favor of or against the development and recognition of specialization in the practice of law. Indeed, it may be said with reasonable accuracy that those who went on record as in favor of the plan were inspired chiefly by the desire that lawyers be better qualified and more expert and that those on the other side were moved largely by their idealistic conception of every lawyer as adequate in all matters and in all situations.

First of all, there is the argument that the law is a seamless web, that a lawyer either knows it all or is no lawyer. There may have been justification for this in the past when the essential of a lawyer was that he approach a problem in a spirit of detachment and with a mind trained to find the logical solution; when, as a hundred years ago, the number of reported cases decided by our federal and state courts was infinitesimal compared with the present figure; when the volume of statute law was a fraction of what it is today; and when administrative law and its numerous subdivisions were unknown. But it simply is not true today. A fine mind, developed by a college education and trained to the legal approach by a law-school course, is not enough.

Specialization is necessary

If lawyers are to be able to compete with non-lawyers who have made themselves expert in a particular field, it is certain that they must devote a large part of their time to training and experience in that field. This will not involve any loss of the special qualifications and abilities that are the traditional possessions of lawyers—ethical standards,

complete integrity, and loyal detachment. Neither does it mean that the lawyer who, because of disinclination or because the particular locality in which he practices does not demand it, has remained a general practitioner will perish from the earth. Personally, I am confident that the demand of the public, particularly in the smaller communities, for the sort of advice and representation which the all-around lawyer can give is sufficient to assure the perpetuation of the traditional type of lawyer side by side with his specialist brother provided, however, that he frankly admits his limitations in special fields and insists on the cooperation of an expert, whether lawyer or layman, when that is appropriate. But, if I am wrong, then what is the use in trying to preserve the generalist in order that he may go through life faithful to his ideals but without clients? To the extent that the Bar loses business to non-lawyers, there will be that much less business for lawyers who are either specialists or generalists. Clearly, the specialist is necessary in order that the Bar may have the largest possible clientele.

A second objection is that it is a disparagement of lawyers to label them as real-estate lawyers or tax lawyers or labor lawyers. But is it? Is it a disparagement of an historian that he studies and writes chiefly about the Renaissance? Or of a scientist that he specializes in electronics? If a human being has studied, trained, and worked—has given his all—in as wide a field as it is possible for a human being to cover, what more can be asked? Are lawyers to set for themselves a standard of mediocrity in an excessively broad field, with the result that laymen concentrate in a small area of the broad expanse which is rightfully the domain of lawyers and give the public an expertness which the lawyers lack?

Only slightly different is the plaint of some lawyer concentrators: "We have spent years persuading the Bar and the public that we are just as much lawyers as any of the rest of you and now you want to classify us as specialists, thereby implying that that is all that we are." The fallacy here is in the implication. Such a lawyer is properly described as a lawyer and something more—a lawyer with special expertness. A learned profession is never the less a profession for being more learned and a member of it loses no standing because he possesses special learning.

Those who are most vocal against specialization complain that to recognize specialization is to create the possibility that the monopoly of the Bar will be broken down. I do not suggest that laymen should be allowed to hold themselves out as qualified to enforce or protect the legal rights of others, either in or out of court. Special qualifications are properly required, but we must be reasonable in defining the limits of the practice of the law. The theory of those who complain that laymen will be encouraged to invade the legal area is that once lawyers admit that no lawyer is completely competent in every field, then the whole argument of the indispensability of the lawyer and his superiority to the layman breaks down. This seems to me unsound. The recognition of a lack of omniscience is no admission that the lawyer lacks other valuable attributes. The true analysis is that there should be combined with general legal training and devotion to standards of integrity, which are the essential attributes of the lawyer, the special expertness which may be acquired and possessed by either a lawyer or a layman. The position that everyone who is admitted to the Bar is competent to advise any client on any problem is untenable. The public is beginning to recognize this, to look further than the license of the lawyer and to ask whether in fact he is competent to take care of all the problems which heretofore have been regarded as legal problems. We are fooling ourselves if we let ourselves believe that we are fooling the public. If the monopoly of the Bar depends for its existence on the myth that every lawyer is competent to advise any client on any matter and can perform with equal proficiency in a police court case and in a complicated corporate reorganization, then the monopoly cannot survive.

There is basis for suspicion that one of the reasons for opposition to specialization within the organized Bar is the fear on the part of the leaders of the interest groups to which I have referred that the establishment of specialty groups with membership conditioned on qualifications would hurt, if not destroy, the standing of the existing groups. It seems to me that there is no basis for the fear.

It is clear to me that the profession is faced with a situation which, if not of recent origin, is at least new in the sense that it has become acute in the last decade; that it presents alternative dangers of a failure, on the one hand, to do all that is necessary to meet the public demand for expert legal service and, on the other hand, to supervise the development so that it will not be carried to the extent of reducing lawyers to the role of narrow technicians; that it is a situation which other professions and quasi-professions, notably the medical profession, have found it advisable to study and direct; and, finally, that it is one concerning which the organized Bar is doing nothing.

As I have have said, I hold no brief here for the plan conceived by officers and committees of the American Bar Association, then crystallized by its Board of Governors and then finally put to death by them. I go no further than to say that the situation calls for a thorough and disinterested study, preferably by some group which is not dominated by lawyers, nor by lay specialists, and supplemented by recommendations which might either outline procedures or advise against any action. ☆

State courts' interest in Treasury practice cannot be ignored—a reply to Mr. Correa

by **REUBEN CLARK, JR.**

LAST month, in these pages I offered the opinion (4 JTAX 216) that the recent Treasury Department "interpretation" of Circular 230 is contradictory on its face: on the one hand, it seems to approve of the fact that accountant-enrollees have for years been satisfactorily applying legal principles in practice before the Department; on the other hand, by its reference to the *Joint Statement of Principles Relating to Practice in the Field of Federal Income Taxation,* it seems to be requiring such enrollees to retain a lawyer if questions arise involving "the application of legal principles." Mathias F. Correa, counsel

to the American Institute of Accountants, took issue with this view. The "Interpretation," he says, can be treated as a consistent whole by regarding the reference to the *Joint Statement* as removing "the whole problem of tax practice" from the field of "unauthorized practice of law" and placing it within "the area of professional responsibility, enforceable by the disciplinary provisions of the two professions." One can doubt that this reading will be as clear to the state courts, from whose jurisdiction "tax practice" is now said to be entirely removed, as it is to Mr. Correa.

The right of state courts to control the practice of tax law outside the limits of Treasury practice as enunciated by the Department is undoubted. Their "power may be exercised to the full as long as its exercise in no way interferes with any Federal function."[1] Accordingly, if this Treasury interpretation places the "practice-of-law"-by-an-enrolled-accountant-without-calling-in-a-lawyer within the "proper sphere" of the lawyer—that is to say, outside the permissible scope of practice for non-lawyers—it follows that local courts are clearly entitled to treat such action as constituting "unauthorized practice of law" under state law. I take it that, assuming the premise, Mr. Correa would not disagree with this conclusion.

However, Mr. Correa contends that this activity by non-lawyers is within the scope of Treasury practice (and, hence, immune from state court interference) although subject "as a matter of professional responsibility" to the possibility that situations may arise where the assistance of a member of the opposite profession should be sought. What is this responsibility? The Treasury interpretation, in a baffling reference, says that "the responsibility of determining when the assistance of a member of the other profession is required . . . follows from . . . the canons of ethics of the American Bar Association and . . . the ethical standards of the accounting profession." How so? It is, of course, a violation of professional canons for an individual to misrepresent his professional status or to hold himself out as a member of another profession.[2] But in the hybrid field of Treasury tax practice, in which all enrollees are clothed with the "same powers" as attorneys with respect to "all matters connected with . . . a client's interests", one is entitled to ask what ethical considerations compel an accountant to call in a lawyer in order to apply legal principles which he is otherwise specifically authorized to apply. Indeed, what ethical considerations exist in states such as New York where, irrespective of express federal sanction, an accountant is authorized by the courts to resolve questions of law for regular clients without calling in a lawyer?[3]

What are ethics requirements?

The answer seems inescapable. Considerations of individual competency or misrepresentation of professional status aside, there is no ethical reason why a lawyer must necessarily call in an accountant, or an enrolled accountant call in a lawyer, within the limits of Treasury practice, simply because "legal principles" or "accounting principles" are involved. Nevertheless, the Treasury Department holds that the canons of ethics of the legal and accounting professions require lawyers and accountants to respect the fields of each other "in accordance with that *Joint Statement*", which exhibits this semantic dichotomy.

If this is the case, the Treasury Department is not foreclosing state courts from continuing to exercise supervision over its practice, for the Department and local courts possess, in effect, concurrent jurisdiction to regulate this practice. The courts have long been free to discipline lawyers for unethical acts comitted wholly before federal courts;[4] it seems clear that they can continue to discipline enrolled lawyers or accountants for unethical conduct consisting of a failure to call in the other when required. Since most states regard the rendering of opinions with respect to "statutes, judicial decisions and departmental rulings" as constituting the practice of law,[5] accountants in tax practice are considerably more likely to run afoul of this particular ethical requirement than are lawyers—as experience has shown. To regard Mr. Agran's activities as falling within the scope of Treasury practice, but nevertheless unethical, offers cold comfort to enrolled accountants now seeking an assurance of legality for their work.

But Mr. Correa tells us, as I read his comments, that the requirement that lawyers and accountants must call in members of the opposite profession is not truly a matter of professional ethics after all, but simply a matter of "professional responsibility"—that the *Joint Statement* was never intended as more than a "guide" to "volutary cooperation." If this is all the *Joint Statement* really meant—that is, if it was no more than an educatonal exercise—this fact will come as a surprise to many persons. How did the Treasury find in it a basis, not otherwise existing, for its requirement that lawyers and accountants must, as a matter of professional ethics, respect each other's spheres in tax practice? Why did the court in the *Agran* case rely on this statement as an alternative ground for its holding? Why did Dean Griswold feel that the AIA's efforts following the *Agran* case to amend Circular 230 were in effect a repudiation of the *Statement*?[6] For that matter, how does Mr. Correa consider it to be enforceable "by the disciplinary provisions of the two professions"? At every step, the *Joint Statement* appears to have been regarded as of considerably more significance in defining the respective roles of lawyers and accountants in tax practice than Mr. Correa suggests.

Mr. Correa's argument comes down, ultimately, to the proposition that the *Joint Statement* was never intended to have binding application to any given factual case and that its incorporation in the Treasury interpretation is without real significance. I hope he is right; the meaningless generalities of the *Joint Statement* deserve to play no part in defining the legal rights and disabilities of lawyers and accountants in Treasury practice. But we are faced with the fact that if state courts are to withdraw from supervision over Treasury practitioners on the grounds that the Treasury Department has preempted the field, they will have to consider the activity of enrolled accountants in applying legal principles without calling in lawyers as both within the permissible scope of practice for non-lawyers and subject to no ethical limitation. It is surely doubtful that, on the basis of this highly ambiguous Treasury statement, local courts will do so in order to concede removal of "the whole problem of tax practice" from their jurisdiction. ☆

[1] In re *Lyon* 301 Mass 30, 16 N.E. 2d. 74, 76 (1938).
[2] Cf., Canon 33 of the Canons of Ethics of the American Bar Association.
[3] Cf., Application of New York County Lawyers Association, in *re Bercu* 273 App. Div. 425, 48 N. Y. S. 2d. 209 (1st Dept. 1948) reversing 188 Misc 406, 69 N. Y. S. 2d. 730 (Sup. Ct. 1947) *aff'd without opinion* 299 N. Y. 728, 87 N. E. 2d. 451 (1949).
[4] Cf. *Gelbel* v. *State Bar of California*, 11 Cal. 2d. 412, 79 P 2d. 1073, cert. denied 305 U.S. 653, rehearing denied 305 U. S. 676 (1938); *Richmond Assn. of Credit Men* v. *Bar Assn. of City of Richmond*, 167 Va. 327, 189 S. E. 153 (1937).
[5] See *Lowell Bar Assn.* v. *Loeb* 315 Mass. 176; 52 N. E. 2d. 27, 33 (1943).
[6] See Griswold, We can Stop the Lawyer-Accountant Conflict over Tax Practice 2 J. Taxation 130, 135 (1955).

TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

OF INTEREST TO TAX PRACTIONERS

When is there tax advantage in using marital deduction? An answer in figures

by RICHARD J. TURK, JR.

Because the marital deduction is so advantageous in most cases many estate planners lapse into the habit of thinking it should be used automatically. This isn't so. Sometimes net tax cost is higher when marital deduction is used. An excellent analysis of when to use, and when not to use, the marital deduction is worked out by Mr. Turk in the following examples. Mr. Turk is a member of the New York Bar.

IN ANY GIVEN CASE, naturally the first problem is whether the marital deduction should be used at all. The following question is asked fairly often:

"What should I do when the assets of the wife and the husband are about equal and both substantial?"

I think the answer is, "It depends." Important considerations are the respective ages of the two spouses and the condition of each one's health. If both are 70 years old, then perhaps the answer should be "No." If both are 50 years old and in good health, or at least if the *spouse* of the one whose will we are working on is in good health, then the answer is probably "Yes."

Income earned on tax saved

If the deduction is used, then during the period between the death of the first spouse and the death of the second, the surviving spouse (or somebody) will have the use of the money which was saved in estate taxes in the estate of the first spouse to die. In the area where most of the estates we are likely to encounter will fall, say, 100,000 to $1,000,000, the peculiar structure of the federal estate-tax rates is such that in a comparatively few years the income from the tax saving in the first estate will more than offset the increase in the over-all estate taxes which may some day result from adding half of the first spouse's estate to the second spouse's taxable estate.

Above a net estate of $100,000, the next federal estate-tax bracket is 30%. Above $1,000,000 it is only 39%. The rates rise quickly and sharply from zero to $100,000; but from there to $1,000,000 the rise is far more gradual; it is almost a plateau.

Suppose a man and his wife are both 50 years old and in good health. We estimate his net estate before the $60,000 exemption at $310,000 and hers at $810,000. It is *his* will that we are drawing.

If he is hit by a taxi tomorrow and leaves $150,000 outright to his wife, the immediate estate tax saving at his death will be $45,000—the difference between $65,700 and $20,700. The $150,000 came off the 30% bracket in the husband's estate and will be added to the 37% bracket in his wife's estate, because she is half a million dollars richer than he. The net increase in the over-all estate taxes is therefore 7% of $150,000, or $10,500. The $45,000 saved at the time of the husband's death by using the marital deduction in his estate, invested at 5%, will produce $2,250 a year; in 5 years it will produce $11,250, or more than the increase in the estate tax. To be sure, this does not take into account the income tax on this income. Even so, if, as is quite possible if not probable, the wife lives 15 or 20 years or more, the use of the money saved at the husband's death certainly should turn out to be worth more than the added estate tax payable on the wife's death.

If we take the exact case put in the question quoted above, viz., two substantial estates of equal amount, the answer is even clearer. Let us suppose the same total, $1,120,000, being equally divided between husband and wife, each thus having $560,000. The husband dies first and uses the marital deduction as to $250,000. Immediate saving at his death, $80,000; annual income on this, $4,000; net increase in over-all estate taxes only $12,500!

Furthermore, and this is a very important and frequently overlooked consideration, the surviving spouse may give away or spend all or a substantial part of what she receives by way of the marital deduction from her husband, or she may leave it to charity. This would reduce or eliminate the added tax in her estate and would increase the advantage of having used the marital deduction in her husband's estate.

Thus, it appears that if both spouses are in reasonably good health and not too old, each may well use the marital deduction to the full extent, since either one may die unexpectedly in the near future and the other may live for years to come.

Formula clauses

Assuming we have decided to use the marital deduction in the particular will we are working on, the next question is, how to go about it.

There has been a lot of discussion, oral and in public print, about the merits of so-called "formula clauses" on the one hand, as opposed to other methods of using the deduction, such as actually or figuratively splitting every asset, or at least every group of assets, vertically down the middle, or some other arrangement. No attempt will be made to discuss the pros and cons of this here. A great many experienced draftsmen and trust men seem to prefer a formula clause, and what is more, a formula expressed in terms of a fraction of the residuary estate. Broadly speaking, a formula clause is one which fixes the amount of the marital deduction outright bequest or trust fund by referring to or incorporating the words of the statute to a greater or less degree. For example, a simple legacy to the wife of "one-half of my adjusted gross estate

as defined in Section 2056 of the Internal Revenue Code of 1954."

There are certain things which should be added to this language in any event. Some of them are mentioned below. Aside from that, there may be certain disadvantages in providing for the marital deduction in this way. Because it is really a cash legacy of a certain amount in dollars and cents, capital gains may occur if this non-residuary legacy is satisfied by distributing in kind securities which have appreciated in value since the testator's death. If someone else is beneficiary of the residuary estate, the widow is likely to be worse off than the residuary beneficiary as to income during the administration period. If there is considerable fluctuation in security values during the administration period, the testator's plan to treat the widow and the residuary beneficiary about equally may be thrown quite out of joint.

All these objections can be overcome if the marital-deduction fund is set up as a fraction of the residuary estate. There is no capital-gains problem. If the widow is beneficiary of one part of the residue and someone else is beneficiary of the other part, they will both be on the same footing so far as allocation of income and sharing the results of market fluctuations are concerned.

Typical fraction-of-the-residue clause

Here is one sample of such a clause. After describing the residue in the usual manner "All the rest, residue and remainder" etc., it says that if the testator's wife shall survive him the residuary estate is to be divided into two parts, to be known as Fund A and Fund B.

Fund A (which is to be the marital-deduction fund) is to consist of a certain fraction of the residuary estate. The numerator of this fraction shall be the amount by which half the adjusted gross estate exceeds the value of all property which shall pass or shall have passed to the testator's wife under the preceding provisions of the will or outside the provisions of the will, either at the testator's death or at any time during his life, with respect to which a marital deduction is allowable to his estate. The denominator of the fraction shall be the amount of the residuary estate at the values used for federal estate-tax purposes. The mathematical result of this formula should be to set aside, as a fraction of the residuary estate, exactly that sum which is needed in order to use up the available balance of the marital deduction. Fund B is to consist of the balance of the residuary estate.

By way of definition, it is then provided that "adjusted gross estate" means the adjusted gross estate as defined in Section 2056 of the U. S. Internal Revenue code or in such other statutory provision as shall correspond thereto at the time of the testator's death; the references to the value of the adjusted gross estate and of property which shall pass or shall have passed to the widow mean in each case the value thereof as finally determined for the purpose of fixing the federal estate tax in the testator's estate; and "marital deduction" means the marital deduction provided for in said Section 2056.

It is further provided, by way of precaution, that anything in the will elsewhere to the contrary notwithstanding, no property, nor the proceeds thereof, which would not qualify for the marital deduction is to be used to constitute any part of the principal of Fund A (in other words, no property which would constitute a terminable interest under the Code is to go into Fund A); and the trustees of Fund A shall neither retain beyond a reasonable time, nor invest in, any property which is not productive of income (this is to meet the requirement, asserted in the Regulations but not supported by any express provision in the Code, that a marital deduction trust fund must be invested in income-producing property).

Common disaster clauses

There is a provision that if the order of death of the testator and his wife cannot be established by proof, then for the purpose of the application of the marital-deduction provisions, but for that purpose only, it shall be conclusively presumed that the testator's wife survived him. Such a provision is expressly authorized by Section 2056 (3) of the Code. Under this the marital deduction is not defeated by the presence in the will of a provision under which the surviving spouse's interest will terminate if she dies within six months after the decedent's death, or if she dies "as a result of a common disaster resulting in the death of the decedent and the surviving spouse," provided such contingency does not in fact occur. The provision may mention both contingencies, or only one of them.

It has long been the custom of many draftsmen to include in a will a provision that if any beneficiary under the will, and the testator, should die in a common accident or disaster (or some similar expression) then all the provisions of the will shall take effect as if such beneficiary had predeceased the testator. This is a sensible provision, intended to obviate double administration expenses and double estate taxes where the beneficiary can never receive any actual enjoyment from the testator's bounty. However, as between a testator and his wife, the use of exactly the reverse provision should result in gaining the benefit of the marital deduction in the husband's estate under circumstances where it might otherwise be lost entirely. If this is done, an appropriate exception should be noted in the general common accident provision if one is used.

Some draftsmen consider it advisable to include a general statement that it is the testator's intention to obtain the maximum marital deduction allowable under the Code; that all the provisions of the will are to be construed and applied so as to give full effect to that intention; and that if the effect of any provision of the will would be to prevent the allowance of the marital deduction, then such provision shall not apply to Fund A, and so far as that fund and its administration are concerned the will shall be read and take effect as if such provision did not exist.

Widow's powers

Thus far the language of our sample clause has been devoted to the creation of a trust fund intended to give the testator's estate the benefit of the maximum marital deduction. The next step is to qualify this fund for the marital deduction. For this purpose the will gives Fund A to trustees named in the will, in trust, to "pay all the net income therefrom annually or at more frequent intervals" (following the wording of the statute) to the widow during her life. There is then given to the widow a general, taxable power to appoint the entire principal of the trust fund by her will at her death, to her estate or to or in trust for the benefit of, any other person or object. There is added a proviso that this power shall be exercisable only by a provision in her will specifically referring to and exercising the power. This is so that she will not inadvertently exercise the power

by a general residuary clause or some blunderbuss provision in her will purporting to exercise any and all powers of appointment which she may have.

Finally, it is provided that any of the principal of Fund A which is not effectively appointed by the wife's will shall be added to the principal of Fund B and follow the disposition thereof in all respects.

Fund A can also be qualified for the marital deduction by giving the widow the unrestricted power to withdraw any or all of the principal of it during her life. On the other hand, neither the trustees nor anyone else may have any power to pay any of the principal to anyone but the widow.

Non-marital-deduction trust

This takes care of the marital-deduction provision proper; but it is also quite important to know what is done about Fund B. In the first place, although it may not be strictly necessary to do so, it would certainly do no harm, and is probably wiser, to say specifically, either in the Fund B part of the residuary clause or elsewhere in the will, that all estate taxes shall be borne by Fund B, and none paid out of Fund A.

In average-sized estates the will usually gives the widow the income for life from Fund B also. It may then well provide that on her death she shall have a nontaxable power of appointment by will over the principal of Fund B. This can be a power to appoint to anyone except herself, her estate, her creditors and the creditors of her estate. Thus, the principal of Fund A, the marital-deduction trust fund, will be taxable at her death but the principal of Fund B will not. A corollary of this fact is that if the will gives the trustee power to invade principal for the wife's benefit during her life, all invasions for her benefit should come first from Fund A. In this way the fund which would otherwise be taxable at her death will be dissipated during her life, and the fund which will not be taxable at her death will be preserved.

If the widow does not exercise her limited power to appoint the principal of Fund B, then after her death it may go outright to the children, continue in trust for them, or what-not. In short, the disposition of Fund B from start to finish is similar to what used to be the customary disposition of the entire residuary estate prior to the advent of the marital deduction.

In large estates, on the other hand, the children may be the first income beneficiaries of Fund B, thus spreading the income over more members of the family and reducing income taxes.

Another way to qualify Fund A for the marital deduction would be to provide that on the widow's death the principal of the trust fund shall fall into her estate; i.e., that it be paid to her executor or administrator as part of her estate. Strictly speaking, this is not a matter of qualifying the trust under the former "trust," now "life estate," provisions of the Code. These provisions, after all, merely create an exception to the terminable interest rule. Rather, by giving every interest in the fund, both life and remainder interests, to the widow and no interest to anyone else, the remainder-to-her-estate plan prevents her interest from ever becoming a terminable interest in the first place.

This arrangement does have the advantage of giving a fresh start at the widow's death, so far as the rule against perpetuities is concerned. On the other hand it would ordinarily result in increased administration expenses both for the marital-deduction trust and for the widow's estate, since the trust would be broken off at her death (somewhat unnecessarily, it seems to me), presumably entailing an accounting, and her probate estate would be larger.

Disclaimers may save much

Section 2056 (d) of the Code treats of disclaimers in connection with the marital deduction. If the surviving spouse disclaims an interest which would otherwise qualify for the marital deduction, naturally the deduction is lost as to that interest. On the other hand, if as the result of a disclaimer by someone else property actually passes from the decedent to the surviving spouse, the marital deduction cannot be allowed with respect to that property.

It can be seen that a total, or partial, disclaimer by the surviving spouse may result in substantial over-all tax savings under certain circumstances. To take a somewhat extreme but graphic case, suppose that A (however unwisely) dies leaving all his estate of $1,000,000 outright by will to his wife B, who already has $2,000,000 of her own. She is 80 years old and in poor health. Under local law, if she renounces her entire interest in A's estate it will go equally to their three children, who have nothing of their own. Such a renunciation is not subject to gift tax. At existing rates there is an indicated over-all estate-tax saving of $65,000 in the two estates combined. This will inure to the children's benefit. In addition, during the remainder of the widow's life the income taxes of the family as a whole should be substantially less than if she had not renounced. ☆

[The accompanying article is adapted from a paper written by Mr. Turk for *The Practical Lawyer*, 133 South 36th Street, Philadelphia 4 ($6 per year). It appeared in their volume 1, No. 6, p. 39; the adaptation is used here with their permission.]

New estate & gift decisions this month

Transfer to trust was in contemplation of death (old law). Decedent and his wife, both being than 62 years, made a transfer in trust of stock and securities owned by them as tenants by the entireties. The trust was irrevocable, and the settlors reserved the income for the joint lives and for the life of the survivor. Decedent died eleven years later. The Court concluded that the nature of the transfers in trust, together with the almost concurrent execution of a will by decedent, and the age and extreme illness of decedent at such time, all pointed to a plan testamentary in nature. The transfer was made in contemplation of death within the meaning of Sec. 811 (c) of the 1939 Code. But since the property transferred was held under a tenancy by the entireties, only one-half of the value so transferred in trust was included in decedent's gross estate. [Under the 1954 Code, transfer made more than three years prior to death cannot be considered as in contemplation of death. *Ed.*] *Estate of Borner*, 25 TC No. 70.

Insurance included in estate; decedent had right to change beneficiary. Although decedent's mother as beneficiary paid all the premiums on eight insurance policies, the decedent possessed the right to change the beneficiary. Possession of such right as an incident of ownership was sufficient to bring the proceeds into his gross estate. *Collin Estate*, 25 TC No. 115.

Value of estate assets determined. The

estate return as filed showed a liability of about $120,000. The Commissioner asserted higher values for stock owned, and also included certain notes owned jointly by the decedent and his wife. On this basis he assessed some $132,000 additional. In extremely brief findings of fact and conclusion of law, the court finds that only about $500 additional of the $132,000 was proper. Refund of the balance is ordered. Nor was a further (unpaid) deficiency of some $304,000 correct. This was based on including additional stock in the estate. The court says merely it was not owned by the decedent. *Farrell Estate (Kingery, Exec.)*, DC Ore., 1/5/56.

Physical incapacity to exercise a power not a release. [*Certiorari denied*] Decedent had a general power of appointment (created in 1931) which she fully exercised in her will (executed in 1940) in favor of certain of her relatives. She died in 1949. Under the Code, if a pre-1942 power has been partially released so that the holder cannot exercise it in favor of himself, his creditors, his estate or his estate creditors, the power is not a general power of appointment includible in the taxable estate. The estate made the ingenious argument that since decedent provided for the exercise of her power for a limited group in the will drawn prior to 1942 and she thereafter became physically incapacitated and remained so until her death, she in effect irrevocably released her right to exercise the power "generally." The district court disagreed and its holding was affirmed by CA-2. Decedent's incapacity subsequent to execution of the will may have had the same effect as a partial release, but does not come within the statutory intentional release. *Simmons Estate*, CA-2, 10/24/55, *cert. den.* 1/16/56.

Revocable trust taxable in grantor's estate; value of children's support rights determined. [*Certiorari denied.*] Taxpayer created a trust with income to go to his children. The trust was revocable by him, with the consent of his wife, while they were both alive. Subsequently, taxpayer and his wife were divorced. The property settlement agreement incident to the divorce provided that the trust income for the children was in full satisfaction of the taxpayer's obligation for their support. The taxpayer's estate claims that the corpus of the trust, although revocable, was not includible in the taxable gross estate because the transfer was made for adequate and full consideration—the discharge of the legal obligation to support the children. Furthermore, the estate argued, the value of the support obligation was the full corpus of the trust because that was the amount agreed on in arm's-length negotiations and confirmed by the divorce court. The Eighth Circuit agreed that the corpus of the trust includible in the taxable estate should be reduced by the value of the support rights, but held that in determining that value, it was not bound by the agreement between the parents. *McDonald Estate (Chase Natl. Bank, Exec.)*, CA-8, 9/15/55, *cert. den.* 2/27/56.

Can't deduct payment to charity out of post-mortem income. Decedent left the residue of her estate to charity. However, as of the date of death, expenses and specific bequests took the entire estate. The estate-tax return claimed no charitable deduction. During administration the estate earned considerable income, which under state law was corpus. With this addition there was a substantial residue for charity. The estate claimed refund. In effect it wished to treat estate taxes and nondeductible items as being paid out of this income. The court denies the refund. It noted that the federal taxes were paid long before the executors formally transferred the income to corpus. The tax must be assessed on the basis of facts as of the date of death. There is no inequity here—the charitable contribution can be deducted on the income-tax return. *Patterson Estate (Waldrop, Exec.)*, Ct. Cls., 1/31/56.

Pre-1931 trust not tax-free; it was revocable, May v. Heiner wasn't. In 1924 decedent created a trust in which she reserved a life estate. The trust was revocable by her husband, whose adverse interest was small. The husband died in 1933, the decedent in 1950. Her estate claimed that the corpus of the trust was not includible in her estate. This was a trust of the type held nontaxable by the Supreme Court in *May v. Heiner* (1931) and made taxable, but not retroactively, by legislation immediately thereafter. When further Supreme Court action (the *Church* case) in 1949 specifically overruled *May v. Heiner*, Congress acted to preserve as nontaxable the pre-1931 trusts of decedents dying in 1950 or prior. The majority held that the corpus was includible in the estate. *May v. Heiner* was an irrevocable trust and this one was, for all practical purposes, revocable. The word "transfer" used in the 1931 and 1944 legislation must be read as referring to irrevocable transfers.

Two judges dissent. There is no reason in the words of the statute or the legislative history to restrict the word "transfer" to mean anything other than transfer of legal title. Moreover, the exclusion from the Technical Changes Act of 1949 of trusts revocable then, implies that those revocable prior but not then (as in this case) are covered. *Miller Estate (Smith, Exec.)*, Ct. Cls., 1/31/56.

Life tenant's estate includes property she could have sold. Decedent had a life interest in property, remainder to her brothers; but she also had the right to sell the property and keep the proceeds. This right, the court holds, was in effect a reversionary interest (she could, by selling, obtain the remainder for herself). Since this interest was worth more than 5%, the entire value is includible in her estate. *Ricketson Estate (Peoples First Natl. Bank, Exec.)*, DC Pa., 1/25/56.

Insurance found community property; no marital deduction for it. Decedent's husband paid the premiums and had rights in policies in on her life. Because the premiums were paid out of community funds (his earnings) the policies were community property. One-half of the cash-surrender value is includible in her estate. However, no marital deduction is allowable for community property. The marital deduction was added to the law to remove the discrimination against non-community states. It is not allowable to community property. *Stromberg Estate (Calif. Tr., Exec.)*, DC Calif., 12/14/55.

Gifts to minors via nominees qualify for gift-tax exclusion. Some state laws require a gift of nonbearer securities to a minor be registered in the name of the donor, the name of any adult member of the minor's family, or in the name of the minor's guardian as custodian for the minor. Bearer securities must be delivered to an adult member of the minor's family, other than the donor, as custodian, accompanied by a deed of gift. Such transfers constitute a completed gift and qualify for the annual gift-tax exclusion. *Rev. Rul.* 56-86. *(See page 298).*

TAX PLANNING AND

Business management

EDITED BY CHARLES S. LOWRIMORE, Sr., CPA

Two classes of stock: one gets cash, one stock dividends; a useful tax planning tool

A NEW FORM OF CAPITALIZATION is being talked around tax-planning circles, which we think has real merit for the company wanting to build up accumulated earnings for reinvestment, yet provide some income to stockholders. The beauty of the plan is that it gives the equivalent of income to stockholders, varying between cash and stock dividends according to the tax needs of the stockholders.

Recently *Business Week* reported on the plan of Citizens Utilities Company of Stamford, Connecticut, to divide its common stock into two classes; later Research Institute of America in its *Taxation Report* made reference to the use of two classes of common stock. Standard and Poor's issued on February 10, 1956 its report 201 on Citizens Utilities and announced that the shareholders of the company has approved the plan for reclassifying the common stock as Series A, paying only stock dividends, and Series B, paying only cash dividends.

The plan provides for the exchange of old shares for the new series, the present shareholders having a choice as to which class of the new shares they will take in the exchange. Both Series A and Series B will rank equally with respect to the sharing in earnings and profits and in the assets at liquidation. The only exception to equal rank of both series is with respect to the Series A stock issued as a dividend on Series A stock, which new stock issued as a dividend on the Series A will be equated annually to the cash dividends issued on the Series B stock.

The Series A shares paying only stock dividends will be exchangeable for Series B shares paying only cash dividends. But, the Series B shares cannot be exchanged for the Series A shares. This exchange of Series A shares for Series B shares could not take place during the period between the declaration and record dates of cash dividends. When dividends are paid on one class the other class will also receive dividends. The value of the stock dividend paid on the Series A stock will be equated in terms of market price, at the dividend date, to the value of the cash dividend paid.

Here is how it works

A corporation with 100 shareholders holding 1,000 shares each of common stock with a total par value of $1,000,000, or $10 per share, divides the stock into the two classes A and B. At the beginning of the year the corporation has accumulated earnings of $1,000,000 the stock has a book value of $20 per share. The corporation has consistently paid dividends on its common stock at the rate of $3 per share on its earnings of $4 per share or $400,000 annually after taxes. Under these circumstances the corporation has paid out in cash $300,000 for 10 years and has accumulated $100,000 each year for 10 years. Because of the $3 rate of return the stock has been selling for approximately $50 per share yielding 6%.

In the exchange 70 of the shareholders receive 70,000 shares of Class A stock, which pays only stock dividends, and 30 shareholders receive 30,000 shares of the Class B stock paying only cash dividends. The corporation maintains its cash dividend rate of $3 per share and pays out $90,000 in cash, and on the same dividend date issues shares to the Class A shareholders with a value of $210,000, the number of shares being determined by the prevailing market price, of $50 per share as 4,200 shares.

The equities of the two classes of shareholders would appear on the records as shown in Table I.

Result after payment of dividend

In the past the company had paid out in cash $300,000 each year but under the new arrangement the object of the plan is accomplished to the extent of retaining in the shareholders' equities accounts an additional $210,000 which can be used in its expansion and growth program.

Equity financing costs are entirely eliminated on the retained earnings, and in the process, because of the additional retention of earnings, it is conceivable that the corporation could raise additional equity capital at less cost than would be the case if 75% of earnings had been paid out in dividends.

Equating value of two classes

As shown above, the book value of the Class A stock is $22.6415 per share while the book value of the Class B stock is $21.00 per share. Following exactly the statement in Standard and Poor's report, with respect to Citizens Utilities, it appears that the value of the Series A stock must be equated to the value of the Series B stock. The book value per share of the Class A shares is greater, because of the market value factor used in determining the number of shares to be issued in Class A stock, than the book value of the Class

TABLE I.—WHAT EACH CLASS OF STOCK GETS

	Class A—Stock Dividends		Class B—Cash Dividends	
	Shares	*Amount*	*Shares*	*Amount*
Shareholders' beginning equities	70,000	$1,400,000	30,000	$600,000
Earnings in current year $4 share		280,000		120,000
Total shareholders' equities		1,680,000		720,000
Cash dividends paid $3 share		0		90,000
New Class A shares issued $50 share	4,200			
TOTALS	74,200	1,680,000	30,000	630,000
Book value per share of the 2 classes		$22.6415		$21.00

B, which shows its book value of $20 plus $4 of earnings less $3 dividend.

In our opinion, the plan has real merit and if administered strictly for the purpose of providing, from earnings and profits, additional equity to be used in expansion and growth of a corporation it will greatly benefit the shareholders.

Shareholders' reasons for choosing

If a shareholder is in a high tax bracket and does not need current cash income it is an opportunity to build up a valuable capital asset in the Class A stock, which is convertible into Class B stock. Should the holder of the Class A stock decide that he is holding too great a proportion of the Class A and needs to supplement his cash income he will surrender Class A and receive in exchange the Class B. However, there may be gain or loss in the conversion.

The shareholders who elect to take Class B stock or who later convert Class A to Class B will receive only cash dividends. The Class B stock can not be converted to Class A stock.

Improper accumulation of earnings

In the case of the utilities company with its established program of growth and expansion it is very unlikely that the penalty tax on "improper accumulation of earnings" would be imposed. However, it is necessary that management look carefully into Section 531 of the Internal Revenue Code of 1954 to avoid that tax pitfall.

Changing ownership and equities

Common stock has several characteristices which are related to equality of sharing in the earnings and profits and the assets of the corporation. Generally, this equality is evidenced by the degree of management control through voting rights provided either in the corporate charter or by-laws.

In the case of the Class A and the Class B stock there is a provision which requires the issuing of Class A stock dividends every time a cash dividend is paid on the Class B stock. It is obvious that the equity ownership changes each time a dividend is paid and the additional stock issued.

If there was a preemptive right available to the shareholders under the ownership of the old stock it is lost with respect to the new Class B stock, except in the case of a new issue of additionally authorized stock.

We think here lies an opportunity for the Class A shareholders to acquire sufficient stock to eventually freeze out the Class B shareholders.

Dilution of the per share value

It does not appear that there will be an actual dilution of the dollar value of either Class A or Class B stock, if such values are annually equated. However, there is a dilution of the Class A share value when dividends are issued in stock at a market price greater than book value, if the annual equation is to be made on a basis of book value.

Stock values and market prices

At the time of taking the first dividend in the example the market price of the stock was $50 per share, and the Class A shareholders on that basis received as a dividend 4,200 shares of Class A stock in lieu of cash amounting to $210,000. The corporation in the second year after the exchange earns profits, after taxes, of $500,000 and decides to increase its dividend payment from $3 to $4 per share. The Class B shareholders will receive $120,000 in cash and the Class A shareholders will receive new Class A shares with a total market value of $296,800. Assume that the dividend news has been made public and the stock rises in proportion to the yield at 6% on the market price, which would be approximately $67 per share.

Proportionate value of stock

At the end of the year in which the increased dividend is paid the result shown in Table II would occur with respect to market value of each.

Tax consequence to corporation

It is understood that the Treasury Department may have conceded that the exchange of the old stock for the new was a nontaxable exchange in one case, but, it may change its position and consider such a transaction a taxable event. This view is based upon two propositions; (1) The old common stock had the right to both cash and stock dividends proportionately, (2) the new Class A has given up its right to a cash dividend and the new Class B has given up its right to a stock dividend.

The question of an "improper accumulation of earnings" and the possible tax consequences have been commented on above.

Tax consequences to shareholders

The Class A shareholders who hope to realize capital gains on the sale of their shares may be disappointed, if the Treasury Department should take the position that one class or the other is preferred stock. For example, if the Class A shareholders are held to be preferred shareholders any subsequent sale, redemption or other disposition might result in ordinary income as an IRC Section 306 dividend.

The stock dividends paid on the Class A stock might also be held to be a fully taxable dividend as ordinary income because the original exchange offered to shareholders the option of either taking the Class A stock paying only stock dividends or the Class B stock paying only cash dividends. Similarly, the same position may be taken with respect to conversion of Class A stock to Class B stock. See IRC Section 305 (b) distributions in lieu of money.

Conclusion

In any case, where a transaction of this kind is contemplated, it is wise to request a ruling and closing agreement from the Treasury Department. The request should cover the corporation's problems and in addition the problems of the shareholders, who will be directly affected. It will be interesting to see how the Treasury will treat the exchange of stock of one class for that of two different classes, with different rights and changing proportionate interests, and whether or not stock dividends received under the conditions set forth will be treated as ordinary income, when the stock received as such dividends are disposed of are redeemed. ☆

TABLE II.—AFTER-DIVIDEND RESULT

Market value of Class A shares	@ $67-new issue	74,200	shrs	
Market value of Class A shares	@ $67-old issue	4,430	shrs	
Total—Class A shares	72.38%	78,630	shrs	$5,268,210
Market value of Class B shares	@ $67-27.62%	30,000	shrs	2,010,000
Total all shares	100%	108,630	shrs	$7,278,210

CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

Careful wording of merger agreement needed to preserve rights of optionholders

THE PROPOSED REGULATIONS on employee stock options say nothing about the effect on qualification which trading on the stock exchange may exert upon stocks of companies about to be merged or consolidated. The point may jeopardize the rights of optionholders and needs explication, says Fred W. Peel (of Alvord and Alvord, Washington, D. C.). Mr. Peel, who has testified at much greater length on this subject at the hearings on the proposed Regulations, writes in part:

The nature of the problem

Suppose Corporation A, with employee stock options outstanding which qualify as restricted under Section 421, is merged into Corporation B, with each Corporation A shareholder receiving one share of B stock in exchange for two shares of A stock. The obvious treatment of the Corporation A optionholders would be to give them options on B stock in the same ratio as the exchange of A for B stock by the A stockholders—that is, an option to acquire two shares of A stock at $8 a share would be exchanged for an option on one share of B stock at $16 a share. This would be treating the optionholders exactly as the shareholders are being treated, and it would be treatment to which the optionholders are probably legally entitled.

However, if the stocks of the two corporations are traded on exchanges, there is a strong danger that the Internal Revenue Service will hold that the options no longer qualify. The Service has refused to rule that such an exchange of option rights will qualify under Section 421 (g) (1); responsible officials have indicated that conforming to the ratio of the exchange of stock is not sufficient; and the proposed Regulations under Section 421 are silent on the point.

The difficulty is in interpretation of the requirement of Section 421 (g) (1) that the aggregate spread between the option price and the fair market value of the shares subject to option immediately after the merger, consolidation, etc. must not be more than the aggregate spread immediately before the transaction. Instead of recognizing that by adopting the same ratio of exchange for options on shares as for the shares themselves the aggregate spread before and after the merger or other transaction will automatically be exactly equal, the Service appears inclined to rely on the less exact indicia of market quotations.

In the earlier example, as the prospects for the merger in which two shares of Corporation A stock will be exchanged for one share of Corporation B stock become more firm as the date fixed for the merger approaches, the price of the A stock will come closer to a two-for-one ratio with the price of the B stock. Market quotations of A stock will reflect primarily an attempt to conform with (and predict) the price of B stock. The market value of Corporation A as such will be pertinent only in valuing B stock.

Why prices don't match

If the stocks of the two corporations are traded in extensively, the price of A stock before the merger will not be exactly half the price of the B stock after the merger. This is accounted for by, among others, the following factors:

1. The possibility (which always exists) that the merger will not occur, possibly due to an injunction;

2. The fact that the price of the B stock is itself subject to fluctuations prior to the merger, so that traders in A stock will not always be able to guess the price of the B stock with exact accuracy, with the result that the price of the A stock will not exactly reflect the ratio of the exchange prior to the merger;

3. The fact that the price of the B stock after the merger may reflect a number of new factors which did not influence its price prior to the merger—i.e., the price on the day after the merger will be influenced by general market conditions, changes in prospects for its line of business, stock tips, etc.;

4. If the two stocks are traded on exchanges in different time zones, there will be at least minute fluctuations in market price after the earlier exchange closes. All of these are imperfections in the market which prevent market quotations from being precisely accurate measures of the relative value of the stocks and the options immediately before as compared with immediately after the merger.

A further imperfection in the use of market quotations arises for the difficulty of choosing among the various market quotations (the median of the high and low, and average of quotes for several days, the closing quote before the merger and the opening quote after it, etc.). The differences between them may be unimportant for most purposes, but if the optionholder is held to a standard under which the most minute increase in spread of market price over option price is fatal to qualification under Section 421, the choice of method of measuring market quotations becomes vital; and in actively traded stocks, no two methods will produce the same result.

The market mechanism is attempting to achieve an equation of values of the two stocks immediately before the merger which is in exact accord with the ratio in which the stock of the merged corporation will be exchanged. As explained above, imperfections prevent this from being achieved exactly by the market. But it is nonetheless a fact that the value of the stock of the merged corporation the moment before the merger is exactly equal to its value the moment immediately after the merger of the stock of the continuing corporation received in exchange. This is so regardless of any variations in the intrinsic values of the two corporations, because it follows from the exchange ratio fixed by the terms of the merger agreement. Likewise, if stock options are exchanged in accordance with the same ratio, they also have exactly the same value the moment immediately before and the moment immediately after the exchange; consequently they meet the terms of Section 421 (g) (1) explicitly and precisely.

When the Regulations under Section

421 are issued in final form they should provide that exchange of stock options in the same ratio as the exchange of stock (with adjustments in option price based on the same ratio) is, by definition, in compliance with the requirements of Section 421 (g) (1). This is the technically proper result under the language of the statute, and a contrary interpretation would to a large degree negate the intent of Congress in writing Section 421 (g) into the law.

As a stop-gap, pending clarification of the point by the Service, the rights of the optionholders of the merged corporation under Section 421 can be preserved temporarily by careful wording of the merger agreement. Instead of merely making provision for an exchange of option rights in an exact, predetermined ratio, the exchange ratio specified can be qualified by a provision that it shall be subject to such adjustments as may be necessary to preserve the options as employee stock options meeting the tests of Section 421 of the Internal Revenue Code.

Such a qualification in the merger agreement is not, of course, a solution to the problem. The problem is still present when the employee attempts to exercise his option. It does, however, permit the merger or other transaction to go through without immediately jeopardizing the rights of the employee optionholders and defers decision for a time with the hope that the Service will clarify its views. ☆

New decisions

Salary of corporate officer is business income in computation of a net operating loss. Taxpayer was employed as president, treasurer, and director of a corporation of which he was the sole stockholder. In 1947, he received a salary of $52,000, but had a net less of about $19,000 resulting from nonbusiness deductions. In making the computations for a net operating loss carryback, which for an individual allows nonbusiness deductions only to the extent of nonbusiness income, the taxpayer contended that his salary was nonbusiness income. The court disagrees, holding that taxpayer's business was that of rendering services for pay, and his salary was earned in that business. *Folker*, CA-2, 2/29/56.

No income on exercise of compensatory stock option; executive couldn't sell the stock. Taxpayer was an executive of Schenley Distillers. In 1948, Household Finance Corporation induced him to take an executive position with them by agreeing to give him an option to buy Household Finance stock below its market value. He accepted the position with them, and in 1949 purchased 10,000 shares of the corporation's stock, with money loaned by a subsidiary, for $18.75 a share when the value on the New York Stock Exchange was $33.75. The court holds that this option was granted as an employment inducement and was substantially compensatory in nature. The taxpayer had, however, orally agreed not to dispose of the stock while in the employment of the corporations. Furthermore,, the SEC provides that an officer of a corporation must turn over to the corporation any profit from the purchase and sale of corporate stock within a period of less than six months. The six-month period did not end in 1949, the taxable year here in issue. Taxpayer argued that these restrictions reduced the fair market value of the stock so that his purchase was no bargain. The court agreed he did not realize income on the exercise of the option or at any time in 1949. The court noted: "Whether there is some other formula by which such gain can be ascertained, either in 1949 (the year of the purchase of the stock) or some other year, we are not called upon to decide." *MacDonald*, CA-7, 2/13/56.

Stock option given wife additional compensation to husband. Andre Bulova, chairman of the board of Bulova Watch, in 1944 granted taxpayer's wife a favorable stock option to purchase Bulova stock over a period of three years. The option was granted as an inducement to taxpayer to come to New York to work for the company, and was conditioned on taxpayer's continued employment. The court finds the option was given as additional compensation to the husband and not for the purpose of enabling the wife to acquire a proprietary interest. Therefore, when she exercised the option and bought the stock, the excess of the value of the stock over the option price was taxable to the husband as additional compensation. *Kane*, 25 TC No. 136.

Profit-sharing bonus accrues in year profit was earned. Taxpayer claimed that its liability for additional compensation based on profit did not accrue until paid, because the board of directors could end the plan at any time. The court finds the board could not rescind the plan as to this particular year after the year closed. It was a liability of the year the profit was earned. *Avco Manufacturing Corp.*, 25 TC 111.

Widow's retirement income not reduced by VA death benefits. Death compensation paid by the Veterans Administration to a veteran's widow does not reduce the widow's retirement income on which the retirement income credit is based. *Rev. Rul.* 56-42.

Beneficiary managing trust property is not an employee. The trustee having no right to control or manage the trust property, a beneficiary managed it. He is not an employee of the trustee. *Rev. Rul.* 56-36.

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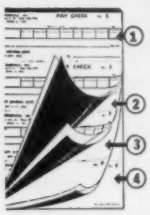

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TAXATION OF

Partnerships

EDITED BY ROBERT M. MUSSELMAN, LL.B., CPA

Limited partnership has two special advantages in raising money from the rich

AN ENTREPRENEUR OR PROMOTER trying to raise capital in large chunks must necessarily expect to get most of it from among the wealthy, who can afford the long-shot gamble without endangering their economic security. With the wealthy one can expect two preoccupations. First, although they are subjecting to risk of loss a determinable portion of their personal capital, they wish to insulate their other assets from the same risk of loss. Second, they are much concerned with the tax consequences of their investments. As to this latter, the potential investor must be shown that any loss will be fully deductible, preferably in the year of loss; that any resulting profits will be taxed at as low a rate as possible; and that a large proportion of his return on the investment will be tax-free.

The dilemma: How to supply the investor limited liability and yet not limit his losses to those of a worthless corporate obligation. In the event of loss, the worthless stock or corporate bond would be a capital loss, such loss being limited to $1,000 deductible against ordinary income for only six years, assuming no capital gains during that time.

Edward O. Lutz, CPA, of Brooklyn College points out that in many situations, you can raise capital by establishing a limited partnership. Mr. Lutz has done a good deal of work with theatrical limited partnerships, a field particularly suited to this form of organization, and a field in which they are being developed to perhaps their highest form, for which reason we asked him for his comments on use of such partnerships in tax planning. He gives us the following:

A limited partnership, properly organized, can meet both of these requirements. It qualifies under the Code sections relating to partnerships if it complies with local law, if the life of the organization terminates upon the death of a general partner[1] or by transfer of his participating interest, and if the partnership agreement provides for the right of participation in the general management by all general partners. (There need be only one general partner in most jurisdictions.)

Limited-partnership pacts provide that the limited partners (investors) will not be liable beyond their capital subscription for the debts or losses of these partnerships. On the other hand, by being classed as partnerships for tax purposes, an investing (limited) partner can cut his losses in that he is permitted to deduct in full, as ordinary losses in the year sustained, his own distributable share in the partnership losses.

Some further tax advantages are also available. If the general partner is a promoter without funds to invest, it may be agreed that the limited partner(s) shall first recoup the original investment before the general partner shall share in profits with the limited partner-investor(s). To the extent, therefore, that funds are returned to investors in excess of reportable profits, they will come tax-free. The source of such distributions might be (1) excess original capital no longer needed, (2) accumulated depreciation, amortization, or depletion. Accumulated earnings (the source of taxable distributions) are kept low by a policy of completely expensing assets against income. This is allowed in many speculative ventures because one cannot predict the economic life of the assets; they are special and become worthless should the property be abandoned. For example, the tangible assets of a theatre production—sets, costumes, stage furniture and properties—are expensed as soon as created or purchased, for their life is indeterminate: the unpredictable mood of the critics and the public, not physical usefulness, determines their useful life span. The discovery and development costs of a test mine shaft are expensible by statute, as are all intangible drilling costs for oil.

In the event of profit, since partnerships are not subject to federal income tax, there is no double taxation on the distributed profit present in corporation set-ups. Also, the sale of a partnership interest at a profit results quite clearly under present law in a capital gain.

Another interesting aspect of limited partnerships lies in the fact that the law grants the general partners exclusive and complete managerial control. Should a limited partner enter directly in the management, he could be held to be an ostensible general partner and thereby lose his immunity to personal liability for the partnership debts. This particular feature is quite attractive to entrepreneurs.

Finally, none of the advantages of the corporate tax rate are irrevocably lost in that the present Internal Revenue Code (Section 1361) allows a partnership to elect to be taxed as a corporation under most conditions.

Still further advantages are gained from partnership organization (over corporations) when the property involves exploitation of patents or real estate.

Extension of real estate provision

The Senate Finance Committee has just approved HR 6712 which would extend to certain forms of organization —presumably partnerships, among others —the provisions of Section 1237. This section grants capital gains treatment to sellers of real estate under certain circumstances.

A holder of a patent, who is the creator or who acquired his interest

[1] The Research Institute of America reported, on February 23, 1956, that "the Treasury now feels that some of the limited partnerships with large numbers of inactive limited partners are pretty close to *associations taxable as corporations*. It had previously been willing to rule that a valid partnership existed as long as the partnership agreement provided for a termination on death of a general partner. We understand that such a provision of itself will no longer insure a favorable ruling under the new, tougher attitude. The Treasury will look *beyond* the agreement to see whether's there's a real partnership—one which is truly *interrupted* by death of a partner. If a limited partnership is used primarily to bring together a group of investors whose money will be used by a centralized management to conduct a business of indefinite duration, the Treasury may insist that it's taxable as a corporation even if there are provisions for a theoretical termination on death."

under certain conditions (payment of money or property to the creator prior to the time the patent was reduced to practice), is assured capital-gains treatment upon sale of the patent right or an undivided interest in it. Apparently a partnership would qualify as a "holder", although a corporation definitely would not (Section 1235).

The owner of real estate, who is not a dealer, is permitted to subdivide his property under certain conditions and still obtain capital-gains treatment only to "real property in the hands of a taxpayer *other than a corporation*" (Section 1237). ☆

New decisions

Children who inherited father's partnership interest not taxed as partners. Taxpayer's husband, who died intestate, had a one-half interest in one partnership and a one-seventh interest in another. Under state law his wife inherited one-third of these partnership interests, and his 5 minor children two-thirds. Taxpayer continued business operations with the other partners. The court holds that no part of the partnership income could be attributed to the children since the children were never regarded or held out as partners. *Linsenmeyer*, 25 TC No. 127.

No loss on liquidation of partnership following sale of assets to partners corporation; really one step. Taxpayer and his partner had the partnership sell its assets to a corporation owned by them and their families. The taxpayer had acquired part of his interest by buying out third partner for some $17,000 in excess of the book value of his interest. Consequently, when the partnership, in liquidation, distributed the proceeds of sale of its assets, the taxpayer received $17,000 less than his basis. This he claimed as a loss. The Tax Court disallowed the loss. In effect, taxpayer sold his partnership interest to a corporation in which he owned directly or indirectly 50% of the stock, and such a loss is disallowed by statute. This court affirms. *Busche*, CA-5, 2/7/56.

Partner's distributive share taxable when earned, not when received. Taxpayer was to receive 5% of partnership gross sales in addition to 25% of the partnership net income or loss as his distributive share. He failed to receive the 5% for several years until he threatened litigation. The court holds the 5% taxable to the partner in the years earned whether or not actually distributed to him. The fact that distribution may have been delayed because of a dispute between the partners was immaterial for tax purposes. *Klein*, 25 TC No. 118.

Wives not recognized as partners in a dress-manufacturing business. Taxpayers were partners in a dress-manufacturing business. They gave their wives a one-half interest in the business, after which both husbands and wives entered into a partnership agreement. The court holds that for tax purposes, the partnership was ineffective and the husbands were taxable on all the income. After the gift, the wives could have been paid out in government bonds held as assets of the partnership. Thus their capital was clearly not needed. Furthermore, the wives' share of the earnings were used to defray household expenses, indicating that the wives did not have control over their income. The testimony was clear that the wives did not render any services to the partnership. *Schneider*, DC Minn., 2/10/56.

Trusts for children bona fide partners in the father's business. From 1938 on, Thomas Pike was in the oil-drilling business in California. He owned over 50% of the stock of the corporation conducting the business, and his wife and three children owned slightly less than 7% each. The balance was owned by two key employees. In 1944 there were many opportunities in the business, and Mr. Pike was afraid that his employees might go out for themselves. He therefore formed a partnership to conduct drilling operations with rented rigs, in which his two employees each had a 25% interest. The other 50% was divided equally between Mr. Pike, Mrs. Pike, and trusts for the three children. Subsequently, a further partnership was created to drill for oil, with the same partners plus an outsider. Reversing the district court, this court holds that Mrs. Pike and the trusts were partners for tax purposes, and their income taxable to them. The partnerships were set up for good business reasons. Furthermore, their operations paralleled the corporation's business, and Mrs. Pike and the children owned stock in the corporation. It is believed that they would have had legal grounds to object if they had not been permitted to participate in the partnerships. In addition, the employees and the outsider rendered the most important services in both ventures. In view of these considerations, the fact that the capital contributed to the first partnership originated in gifts by Mr. Pike did not invalidate the bona fides of the trusts' interests. The capital for the second partnership came from the profits of the first one. One judge dissented on that ground that the findings of fact of the trial court were not supported by substantial evidence. *Pike*, CA-9, 2/16/56.

Jury finds family partnership valid. The Herr Manufacturing Company was organized in 1907. In 1942, the taxpayer gave each of his four children a 1/9 interest in the business. The Commissioner pointed out that gift-tax returns covering this transfer had not been filed for some years, but Mr. Herr explained that he had given his lawyer the information, and the lawyer apparently had forgotten to file the appropriate returns. After the gifts, Mr. Herr and his four children entered into a partnership agreement. The Commissioner argued that two of the children rendered no services and were not bona fide partners for tax purposes. Mr. Herr testified that he believed it was for the good of the business that all of the children be treated equally. On the facts, the jury found that the gifts were bona fide and that it was intended that Mr. Herr and his four children were to carry on the business as a partnership of all the parties. *Herr*, DC Pa., 1/17/56.

Partnership did not terminate on the death of a partner. Taxpayer, who died on August 9, 1943, was a member of a partnership which was on a fiscal year ending September 30th. The taxpayer's executor contended that the income for the fiscal year ended September 30, 1943 was taxable to the taxpayer's estate, rather than on the taxpayer's final return. The court so holds. The partnership agreement provided for the continuation of the business for a period of five years. Therefore, since the business continued, the partnership, although technically dissolved, did not terminate. It continued to the end of its normal accounting period, and decedent's distributive share, as determined for such period, was taxable to his estate. *Ebersbach*, CA-6, 2/14/56.

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA, JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

1954 Code helps foreign corporations caught in personal holding company tax

by HARRY J. RUDICK

Ten years ago Professor Harry J. Rudick, writing in the TAX LAW REVIEW, *pointed out a trap which might apply to foreign corporations qualifying as personal holding companies. We asked him to consider the problem under the 1954 Code. As his comment below indicates, the inadvertent trap in the 1939 Code was inadvertently changed in the 1954 Code.*

ALTHOUGH PRIMARILY designed to prevent tax avoidance by high-tax bracket citizens or residents of the United States through accumulation of income in a holding corporation, the personal-holding-company tax from its inception has created problems for certain closely-held foreign corporations which are not, in fact, holding companies.[1] Because of the interplay of the personal-holding-company provisions and Section 882 (b), a foreign manufacturing or trading corporation with United States sources of investment income may be subject to prohibitively high taxes on that income.

Under Section 542 of the 1954 Code, any corporation, whether foreign or domestic, may be a personal holding company if both the gross-income and stock-ownership requirements are fulfilled. The first prerequisite is met if 80% or more of the corporation's gross income for the taxable year consists of personal-holding-company income [Section 542 (a) (1)]. Common examples of such income are interest, dividends, rents (unless certain exceptions apply), royalties, income from estates and trusts, and gains from trading in securities and commodity futures [Section 543 (a)]. The stock ownership requirement is satisfied if more than 50% in value of the corporation's outstanding stock is held, directly or indirectly, by not more than five individuals at any time during the last half of the taxable year [Section 542 (a) (2)].[2] Two exceptions of importance to foreign corporations are made. A "foreign personal holding company" is excluded from the definition of personal holding companies [Section 542 (c) (5)], as is any foreign corporation if (1) its United States gross income for a three-year period is less than half its total gross income and (2) all of its stock during the last half of the taxable year is owned, directly or indirectly, by nonresident alien individuals [Section 542 (c) (10)].

The difficulty caused foreign corporations by these provisions arises from the fact that in the case of a foreign corporation gross income consists, for United States tax purposes only, of gross income from United States sources [Section 882 (b)]. Thus, regardless of the quantum of nonpersonal holding company income from sources outside the United States, a foreign corporation will fulfill the gross-income requirement of the personal-holding-company provisions if 80% or more of its United States income is personal-holding-company income. On its United States income, a closely-held foreign corporation may, therefore, be subject to the almost confiscatory personal-holding-company tax.[3]

The new Code has eliminated the further problem that in certain situations a foreign corporation could not, as could a domestic corporation, avoid the personal-holding-company levy by distributing its income. In computing "undistributed personal holding company income" subject to the special tax under both the old [Section 504 (a)] and new [Section 545 (a)] Codes, dividends may be deducted. Section 27 (i) of the 1939 Code, however, limited the dividend deduction to that part of a dividend which was a taxable dividend "in the hands of such of the shareholders as are subject to taxation." Under this language and in view of the legislative history of Section 27 (i) of the 1939 Code, it seemed that dividends to nonresident alien shareholders would not qualify as an offset in computing undistributed personal-holding-company income because such shareholders might not be subject to United States tax on the dividends.[4] This view was not, however, universal.[5]

The new Code has foreclosed this issue by adopting a broader definition of dividends qualifying for a deduction in computing undistributed personal-holding-company income. Sections 561 and 562 permit a deduction for dividend distributions regardless of whether the recipient of the dividend is subject to United States taxation. Consequently a foreign corporation, as well as a domestic corporation, falling within the ambit of the personal-holding-company provisions may escape the penalty tax by distributing dividends.

While this change has remedied a serious inequity, it is unfortunate that the scope of the application of the personal-holding-company tax to foreign corporations was not re-examined in the passage of the new Code. The need for the imposition of this tax on holding companies owned by citizens or residents of the United States is apparent. But the wisdom of penalizing portfolio investment in the United States by nonresident aliens through foreign operating corporations is questionable. ☆

[Mr. Rudick is a partner of the New York law firm of Lord, Day & Lord, and a well-known writer on taxation.]

[1] In a note written ten years ago, "Personal Holding Companies Owned by Nonresident Aliens," 1 *Tax Law Review* 218 (1946), I reviewed the status and problems of foreign corporations under the personal holding company provisions of the 1939 Code. Most of that discussion is apposite today.

[2] In applying this rule, an individual is treated as owning stock actually owned by certain related individuals or entities.

[3] Section 541 imposes a tax of 75% on the first $2,000 of undistributed personal holding company income and 85% on the excess. (This would be in addition to the ordinary income tax.)

[4] Note 1, at 220 and 221.

[5] See: Singer, "Foreign Personal Holding Companies — a comment on Rudick, Holding Companies Owned by Nonresident Aliens," 1 *Tax Law Review* 440 (1946) and Rudick "Reply," 1 *Tax Law Review* 448 (1946).

U. S. citizen residing abroad has difficult tax problem on stock-option gains

SELLING HIS OPTION may be the best way for the U. S. citizen living abroad to realize on his situation, suggests Arthur Young & Co. In their *Journal* for October, 1955, the accounting firm discusses the exercise of a stock option by a citizen of the United States not subject to United States tax because he is a bona fide resident of a foreign country or because he is physically present in a foreign country for the required 510 days out of eighteen months. The comment, which refers to an option which does not qualify as a "restricted stock option" under Section 421 of the Code, follows:

"Under Section 911, a U. S. citizen residing abroad is not taxed on his 'earned income'. This raises an interesting question in the case of income derived from the exercise of a stock option.

"To illustrate the problem, assume that Mr. A, President of X Company, a Canadian corporation, is a U. S. citizen residing in Canada. In connection with his employment several years ago he was granted a nonrestricted option to purchase 10,000 shares of X stock at $2 par share (fair market value on date option granted). X stock is now worth $10 per share, and Mr. A exercises his option. If he sells the X stock for $10 per share, what will be his tax liability to the U. S.

"It would appear clear that $8 per share is additional compensation, and under usual principles the basis of the stock to Mr. A would therefore be $10 per share. Consequently, a sale at $10 would produce no gain or loss. However, there is a provision of the regulations under the 1939 Code [Reg. 118, Sec. 39.22 (a) -1 (c), provides: 'In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income.'] which may be construed as requiring the use of a $2 basis, in which case Mr. A would have taxable gain of $8.

"It would seem that Mr. A could avoid any question of taxable gain by selling the option itself instead of exercising it. See *W. Winne Cadby*, 24 T.C. No. 97."

The Arthur Young comment suggests several additional problems. For example, the impact of the Canadian income tax in the case illustrated raises some interesting problems. Under Canadian law, the $80,000 appears to be taxable at the time of the exercise of the option. (Income Tax Act, Section 85A). If Mr. A had no income other than his salary, he would have no U. S. tax benefit from the Canadian tax and, of course, could not add the Canadian tax to his basis for the stock. Suppose he had dividend income from U. S. securities (derived from sources within the U. S.). He would still get no credit for the Canadian income tax because of the "per country" limitation under Section 904 of the Internal Revenue Code, which limits the credit to this formula:

Taxable income from Canada divided by taxable income from all sources multiplied by United States income tax. Since the earned income is excluded from gross income by virtue of Section 911, the numerator of the Section 904 fraction is zero and the foreign tax credit allowable is zero.

On the other hand, if Mr. A has marketable securities which have appreciated in value, he may obtain the advantage of the Canadian income tax by selling those securities, in the year in which he exercises or sells his option, provided he sells them in Canada. In that case, he will have no additional Canadian tax, because capital gains are not taxed in Canada. However, the gain on the sale of the marketable securities would probably be considered to be derived from Canadian sources since the sale would occur in Canada. Accordingly, the numerator of the Section 904 fraction would consist of those gains. If these capital gains on the sale of securities were Mr. A's only income, other than his salary and option income, the numerator and denominator of the Section 904 fraction would be identical and the entire Canadian tax imposed on his "earned income" would be applied against the United States capital-gains tax on the sale of the marketable securities. ☆

CED wants more than 14 points foreign reduction

THE COMMITTEE FOR ECONOMIC DEVELOPMENT is urging that the much-spoken-of-14-point reduction on income earned by American business abroad be increased. In its recent study on *Economic Development Abroad and The Role of American Foreign Investment* it said: Tax inventives to investment abroad are potentially an effective way of stimulating private foreign investment. A proposal has been made to reduce by 14 points the Federal corporate income tax on income earned abroad, and to postpone payment of taxes on the earnings of foreign branches of American corporations until the earnings are transferred or repatriated. The committee favors these proposals. We doubt, however, that a 14-point reduction would be enough to stimulate much foreign investment, and we believe consideration should be given to a larger reduction. We would also favor using tax concessions to induce Americans to invest in foreign securities if practical means of doing so can be devised.

At present only corporations which can qualify as "Western Hemisphere trading corporations" under Sections 921 and 922 of the Internal Revenue Act of 1954 are entitled to a 14-point reduction in their income tax. The new proposal would extend the same tax reduction to all domestic corporations with respect to that part of their income which comes from the active conduct of a trade or business abroad.

At present also, foreign *subsidiaries* of American corporations need not pay the Federal corporate income tax until their earnings are received by the parent company in the United States, credit being allowed for any foreign income tax paid by the subsidiary. The new proposal would apply the same rule to foreign *branches* of American corporations, except that the Federal income tax would become payable whenever the branch's earnings were transferred to any other part of the corporation, whether in the United States or abroad.

This study is one of CED's "statements on national policy" prepared by its research and policy committee. CED is a non-profit research and study organization headed by prominent business and intellectual leaders of the nation. ☆

No withholding on income earned in U.S. possessions. Remuneration paid on or after 8/9/55 to a U.S. citizen for services performed in a U.S. possession for an employer other than the U.S. or its agencies, is not subject to federal withholding if such remuneration is subject to withholding for local income taxes. *Rev. Rul.* 56-37.

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

Senate Finance Committee favors wider OASI coverage, opposes greater benefits

EARLY in March the Senate Finance Committee completed public hearings on H. R. 7225 which would amend the Society Security Program in the following respects:

1. Extend coverage
2. Reduce the retirement age for women to 62
3. Permit the payment of disability benefits at age 50
4. Provide monthly benefits for disabled children over 18.

This bill was passed by the House last year without public hearings, so the hearings before the Senate Finance Committee attracted more than the usual attention. Generally, most of the provisions of the bill were supported by labor organizations but opposed by employer associations and women's organizations. While the hearings had been completed as this was written, Secretary Folsom, Head of the Department of Health, Education and Welfare, had not yet presented the administration's viewpoint. It is anticipated, however, that he would recommend further study before enacting the bill. Most legislators are concerned with the additional costs that may result from this bill. The cost element and the disability features drew major attention from the employer associations. Practically all these associations agreed with the first purpose of the bill, i.e., extension of coverage. As an example of the arguments presented by employer associations, we print below excerpts from the testimony before the Committee:

Coverage

We advocate the extension of coverage to all gainfully employed and self-employed persons as an essential element in a sound Social Security system. To do otherwise leaves wide gaps in the the program. Many who contribute to the total national income are presently uncovered, resulting in inequitable treatment of segments of the population. At this time, it behooves the Congress to provide in this law a basic minimum of economic protection.

Reduction in retirement age for women

We believe that the enactment of this provision will defeat the goal for hiring the older worker for the following reasons:

1. Lowering the age of women to 62 will cause a discrimination against the men. To overcome this discrimination, it will result in the reduction of their retirement age as well.

2. Company, industrial, voluntary or government pension plans have grown at an accelerating rate. They are geared to the Social Security Act as to the age of retirement. Lowering the age to 62 will result in many complications in these various types of pension plans.

3. Social Security benefits plus company pension plans have resulted in a larger number of workers retiring each year at age 65. In 1950 only 18% of all persons who reached 65 received OASI benefits. Four years later (June, 1954) this percentage increased to 36%. Lowering the age to 62 both for Social Security and company pensions will facilitate compulsory retirement or induce voluntary retirement at this early age, contrary to the national interest.

4. Companies will hesitate and not be encouraged to hire the older worker.

Other types of discrimination also will result:

1. Lowering the age to 62 for wives of retired workers will cause a discrimination against those with wives under 62. In fact, only 3 out of 10 couples will benefit by this proposal, according to the Chief Actuary of the Social Security Administration. He estimated that of the men claiming benefits at 65, only one-fifth had wives 65 or older while one-half had wives younger than 62. This discrimination will cause a demand in the near future to pay benefits to wives regardless of age. Senator Neuberger has already urged this committee to lower the eligibility for women to 60 instead of 62. He said there are as many wives between 60 and 62 with husbands at the retirement age as there are between 62 and 65.

2. A reduction in the age for working women will make it more difficult for them to obtain and keep jobs on a fair basis with men. This will work a severe hardship on these women who are out of work through no fault of their own. We understand that the National Federation of Business and Professional Women's Clubs has recognized this problem and has gone on record as opposed to the lowering of the retirement age for women to 62.

3. There is no real significance in reducing the retirement age to 62 for widows when there are many younger. The next demand will be made to pay benefits to all widows regardless of age or dependency.

The primary purpose of reducing the age of women to 62 is to create a demand for a still lower retirement age, to encourage the retirement of women at a lower age, and the earlier retirement of men who have younger wives. We do not believe that these purposes will be for the general good and welfare of the people of this country. The loss of buying power and the discouragement of hiring the older worker may, in the future, seriously affect the economy of our country. Before this provision is enacted, we believe that a careful study should be made to ascertain the cost in the future, based upon a population estimate, and its effect on the objectives of our social security program.

Disability benefit at age 50

It appears to us that there is a need to acquire experience under the 1954 disability freeze amendment before cash benefits to the disabled are considered. We understand that under the 1954 amendment state and federal officials in certain instances have not reached agreement on administrative procedures and proper controls necessary for successful operation. Administrative, medical, rehabilitation and control problems where disability benefits are paid are far more serious than those involved in a mere freezing of rights to a benefit due in the future. We believe a success-

ful operating experience under the 1954 amendment is a primary requisite before cash benefits are paid.

It could well be that this is part of a calculated plan by the proponents of this bill to start with disability benefits at age 50, and then next year to urge that disability benefits be paid to all disabled workers regardless of age. The provision as drawn discriminates between workers under and over 50 and it will be asserted that need for disability benefits for those under 50 is just as great or greater for those over 50. After this, the next step would be elimination of the provision which would reduce benefits to a disabled person under OASI when receiving workmen's compensation or similar payments. Where this trend will stop nobody knows.

Disabled children 18 years and older

We are certainly sympathetic with the problem and approve in principle aid to widows with dependent children who are permanently and totally disabled. However, although concerned with the method of solving this problem, we believe that such aid should not be made a part of the Society Security program. States and cities now take care of this problem on the basis of need and not of right. We fear the need to rehabilitate these children will no longer be considered necessary by state and local governments if this provision is enacted. The result may be that such individuals may never have the initiative to engage in gainful employment.

The provision also discriminates against other disabled workers. Permitting disabled children over eighteen to obtain benefits and denying them to others who have been in the labor market will seem unfair to these individuals.

Secretary Folsom appeared before the committee on March 22 and opposed all of the liberalization proposals in the bill. He did endorse the provision extending coverage and also recommended that annual reporting for employers be adopted. More on this later.

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